

LEGAL AND CONSTITUTIONAL HISTORY

WILLIAM E. NELSON

A decade ago I contributed to the *Annual Survey of American Law* my first review of the literature in the field of American legal history.¹ This year I would like to look back over the past ten with the hope of identifying at least some of the continuities and changes in the literature during that period.

Continuities in the Literature.—Many legal historians continue to concentrate on discussions of factual data in their writings about the American legal past. Some legal historians, such as Robert Mennel in *Thorns and Thistles: Juvenile Delinquents in the United States, 1825-1940*,² have enlarged our factual knowledge on a variety of narrow topics.³ Others are still writing books and articles which do little other than cover familiar factual ground.⁴ Such works include Alan Reitman's

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William E. Nelson is Associate Professor of Law at Yale University.

1. See Nelson, *Constitutional History*, 1966 *Ann. Survey Am. L.* 687.

2. R. Mennel, *Thorns and Thistles: Juvenile Delinquents in the United States, 1825-1940* (1973).

3. See Clark, *The Elephant Butte Controversy: A Chapter in the Emergence of Federal Water Law*, 61 *J. Am. Hist.* 1006 (1975); Colburn, *Governor Alfred E. Smith and the Red Scare, 1919-20*, 88 *Pol. Sci. Q.* 423 (1973); Holdsworth, *Adultery or Witchcraft? A New Note on an Old Case in Connecticut*, 48 *N. Eng. Q.* 394 (1975); Johnson, *The Business of War: Trading with the Enemy in English and Early American Law*, 118 *Proc. Am. Phil. Soc'y* 459 (1974); Langum, *Pioneer Justice on the Overland Trails*, 5 *Western Hist. Q.* 421 (1974); Mackey, *An All-Star Debate on Capital Punishment*, Boston, 1854, 110 *Essex Inst. Hist. Coll.* 181 (1974); Planck, *Lincoln's Assassination: More Forgotten Litigation—Ex parte Mudd (1868)*, 75 *Lincoln Herald* 86 (1974); Prude, *Portrait of a Civil Libertarian: The Faith and Fear of Zechariah Chafee, Jr.*, 60 *J. Am. Hist.* 633 (1973); Stanton, *The Presidency and the Purse: Impoundment, 1803-1973*, 45 *Colo. L. Rev.* 25 (1973); Taylor, *The Foreign Attachment Law and the Coming of the Revolution in North Carolina*, 52 *N.C. Hist. Rev.* 20 (1975).

4. See H. Abraham, *Justices and Presidents: A Political History of Appointments to the Supreme Court* (1974); G. Dargo, *Roots of the Republic: A New Perspective on Early American Constitutionalism* (1974); Benedict, *Preserving the Constitution: The Conservative Basis of Radical Reconstruction*, 61 *J. Am. Hist.* 65 (1974); Buchanan, *The Quest for Freedom: A Legal History of the Thirteenth Amendment*, 12 *Houston L. Rev.* 1, 331, 592, 843, 1069 (1974-75); Campbell, *Chancellor Kent, Chief Justice Marshall and the Steamboat Cases*, 25 *Syracuse L. Rev.* 497 (1974); Crawford, *A Footnote on Courts for Trial of Negroes in Colonial Pennsylvania*, 5 *J. Black Stud.* 167 (1974); Duram, *The Labor Union Journals and the Constitutional Issues of the New Deal: The Case for Court Restriction*, 15 *Labor Hist.* 216 (1974); Ehrlich, *The Origins of the Dred Scott Case*, 59 *J. Negro Hist.* 132 (1974); Flanigan, *Criminal Procedure in Slave Trials in the Antebellum South*, 40 *J. So. Hist.* 537 (1974); Gibbons, *The Interdependence of Legitimacy: An Introduction to the Meaning of*

book, *The Pulse of Freedom: American Liberties, 1920-1970's*,⁵ which deals with the struggle for civil liberties in the United States during the past fifty years; Walter Trattner's, *From Poor Law to Welfare State: A History of Social Welfare in America*,⁶ which discusses the history of the nation's social welfare system over the past three centuries; and, Milton Read's article on land tenure in colonial Georgia⁷ which retells how the efforts of Georgia's trustees "to eliminate economic privilege within their model community in America"⁸ resulted in their restricting the size of farms and the tenure by which they were held.

Other essentially factual writing makes a more substantial contribution. In this regard, a valuable contribution is the third volume of *North Carolina Higher-Court Records, 1702-1708*,⁹ part of a series of the records of the General Court of basic common law jurisdiction, the Chancery Court, and the Admiralty Court of North Carolina. The single most important factual contribution has probably been made by Harold Hyman in *A More Perfect Union: The Impact of the Civil War and Reconstruction on the Constitution*.¹⁰ Hyman's erudition is immense; moreover, he conceives of constitutional history as including not only lawyers' law but political theory and administrative development as well. Adrian Cook's detailed study, *The Armies of the Streets: The New York City Draft Riots of 1863*,¹¹ is of special note for its two chapters describing the dreadful conditions of life among the poor of mid-nineteenth century New York.

Five other factually oriented books are also particularly important: Peter Fish's *The Politics of Federal Judicial Administration*,¹² which

Separation of Powers, 5 Seton Hall L. Rev. 435 (1974); Grossman, Wage and Price Controls During the American Revolution, 96 Monthly Labor Rev., Sept. 1973, at 3; Leuchtenburg, A Klansman Joins the Court: The Appointment of Hugo L. Black, 41 U. Chi. L. Rev. 1 (1973); Morgan, Eastman, Gale & Areen, Impeachment: An Historical Overview, 5 Seton Hall L. Rev. 689 (1974); Novak, The College in the Dartmouth College Case: A Reinterpretation, 47 N. Eng. Q. 550 (1974); Oberst, The Strange Career of Plessy v. Ferguson, 15 Ariz. L. Rev. 389 (1973); Risjord, Virginians and the Constitution: A Multivariate Analysis, 31 Wm. & Mary Q. 613 (3d ser. 1974); Roe & Osgood, United States Supreme Court, February Term 1824, 84 Yale L.J. 770 (1975); Strong, The Economic Philosophy of Lochner: Emergence, Embrasure and Emasculation, 15 Ariz. L. Rev. 419 (1973); Van Alstyne, A Critical Guide to Ex parte McCordle, 15 Ariz. L. Rev. 229 (1973).

5. *The Pulse of Freedom: American Liberties, 1920-1970's* (A. Reitman ed. 1975).

6. W. Trattner, *From Poor Law to Welfare State: A History of Social Welfare in America* (1974).

7. Read, Land Tenure in Trusteeship Georgia, 48 Agric. Hist. 353 (1974).

8. Id.

9. *North Carolina Higher Court Records, 1702-1708* (W. Price ed. 1974).

10. H. Hyman, *A More Perfect Union: The Impact of the Civil War and Reconstruction on the Constitution* (1973).

11. A. Cook, *The Armies of the Streets: The New York City Draft Riots of 1863* (1974).

12. P. Fish, *The Politics of Federal Judicial Administration* (1973).

studies the Judicial Conference of the United States, the Administrative Office of the Courts, the Federal Judicial Center, and various administrative agencies at the circuit level; William H. Harbaugh's *Lawyer's Lawyer: The Life of John W. Davis*,¹³ which is a thoroughly detailed study of the life, personality, and career of Davis; Robert M. Ireland's *The County Courts in Antebellum Kentucky*,¹⁴ which contains a wealth of new information about the structure and functioning of the Kentucky county courts; R. Alton Lee's *A History of Regulatory Taxation*,¹⁵ which is a detailed discussion of various federal taxes enacted during the last century for purposes of regulation; and William Twining's *Karl Llewellyn and the Realist Movement*,¹⁶ which includes an introductory section of some seventy pages on the background of the realist movement.

David M. Billikopf, with his *The Exercise Of Judicial Power, 1789-1864*,¹⁷ makes a substantial contribution to early nineteenth century constitutional history by placing largely unknown antebellum circuit and district court decisions in juxtaposition with some more widely known Supreme Court cases. George Fiedler in his general study, *The Illinois Law Courts in Three Centuries, 1673-1973: A Documentary History*,¹⁸ presents new information on the French judicial system that existed during the first century of Illinois's history. He also discusses the jurisdictional confusion that existed between 1764, when the British assumed control of Illinois from the French, and 1790, when the mechanisms of American territorial government finally reached Illinois.

Three articles are also of interest in expanding our available factual information. One, by Robert Seddig, locates the origins of the Supreme Court's unique role in American government in the practice developed by Chief Justice Ellsworth of disposing of cases by unanimous rather than seriatim opinions, in the special political skills of Chief Justice Marshall, and in the need of the Federalist Court to present a united front to the Jefferson administration during the years 1801-1804.¹⁹ An article by Albert Cowdrey²⁰ describes how Section 13 of the Rivers and Harbors Act of 1899, which has recently become a mainstay in the federal statutory scheme of environmental protection, originated as

13. W. Harbaugh, *Lawyer's Lawyer: The Life of John W. Davis* (1973).

14. R. Ireland, *The County Courts in Antebellum Kentucky* (1972).

15. R. A. Lee, *A History of Regulatory Taxation* (1973).

16. W. Twining, *Karl Llewellyn and the Realist Movement* (1973).

17. D. Billikopf, *The Exercise of Judicial Power, 1789-1864* (1973).

18. G. Fiedler, *The Illinois Law Courts in Three Centuries, 1673-1973: A Documentary History* (1973).

19. Seddig, *John Marshall and the Origins of Supreme Court Leadership*, 36 U. Pitt. L. Rev. 785 (1975).

20. Cowdrey, *Pioneering Environmental Law: The Army Corps of Engineers and the Refuse Act*, 44 Pac. Hist. Rev. 331 (1975).

legislation that gave the government power to prevent the obstruction of navigation without having to prove that any particular discharge had, in fact, obstructed a waterway. Steven Schlossman discusses the New York House of Refuge,²¹ an institution established in 1825 as both a prison and a school, a place to "punish as well as to teach."²²

The single most interesting factual claim was made by Harold Chesnin and Geoffrey Hazard concerning the practice of English Chancery courts in the eighteenth century.²³ Chesnin and Hazard reported that issues of fact were ordinarily referred to juries sitting at law whenever there was a substantial conflict in the evidence; they claim that it was only during the nineteenth century that "referral to a jury . . . [became] wholly discretionary and the jury verdict merely advisory."²⁴

This claim has been challenged, however, by John Langbein.²⁵ Langbein concedes that in most cases the Chancellor did refer disputed questions of fact to juries, but contends that the Chancellor had a residual power to decide such questions by himself. It is somewhat difficult to resolve the issue drawn between Langbein, on one hand, and Chesnin and Hazard, on the other, on the basis of the evidence they present. In the few cases that Langbein cites in which the Chancellor did seem to find facts, such findings have a greater resemblance to the granting of summary judgment on a clear written record than to the weighing of credibility and probability of oral testimony in a closely balanced case. More research is needed—research in which American legal historians should be eager to participate. If the Chesnin-Hazard position should turn out to be correct, their position could explain why the crown's program of conferring fact-finding powers on colonial equity judges, powers the Chancellor himself did not possess, seemed to be an unusually "aggressive measure"²⁶ to the colonials and would explain the vigorous opposition in the colonies to the equity courts.

The area in which the largest number of important factual contributions was made is that of black legal history. In her new book, *Black Resistance/White Law*,²⁷ Mary Berry details innumerable instances of the use of federal power, often in a quite bloody manner, to repress

21. See Schlossman, *Juvenile Justice in the Age of Jackson*, 76 *Teach. Col. Rec.* 119 (1974).

22. *Id.* at 133.

23. See Chesnin & Hazard, *Chancery Procedure and the Seventh Amendment: Jury Trial of Issues in Equity Cases Before 1791*, 83 *Yale L.J.* 999 (1974).

24. *Id.* at 1011.

25. See Langbein, *Fact Finding in the English Court of Chancery: A Rebuttal*, 83 *Yale L.J.* 1620 (1974).

26. See Chesnin & Hazard, *supra* note 23, at 1019.

27. M. Berry, *Black Resistance/White Law* (1971).

blacks. Three valuable articles spell out the important role that blacks played in late nineteenth century efforts to secure racial equality. First, John Hope Franklin writes of the efforts of blacks to secure enforcement of the Civil Rights Act of 1875—efforts which failed because of doubts about the Act's constitutionality and the lukewarm attitude of federal enforcement officials.²⁸ The successful efforts of a black state legislator in Ohio, in conjunction with white proponents of equality, to obtain passage of an anti-lynching law in the mid 1890's were examined by David Gerber in a 1974 article.²⁹ Finally, Dale Somers explores the development of new equalitarian racial attitudes in New Orleans as a result of effective black leadership supported by black voters and the use of federal power during the two decades after the Civil War.³⁰ He notes that, although racial discrimination did persist during the period of 1865-1900, flexible racial practices arose based on day-to-day needs and demands of ordinary citizens. For at least two decades after the war, "residents from the rank and file of both races played and worked together on amicable, harmonious, even equalitarian terms."³¹ Toward the end of the century, these individual practices were reversed by legislation as whites demanded and imposed racial segregation.

Another article, discussing the controversy in Kentucky between state and federal authorities concerning whether testimony of blacks should be admissible in trials, shows that even in border states federal officials worked hard for black equality.³² According to its author, Victor Howard, "by January, 1869, the docket of the federal court had become largely a calender of cases tried under state law by the federal court due to the denial of equality of testimony in state courts. Besides the large number of cases that were taken directly before the federal court, many were transferred before trial and others on appeal from state courts."³³

Despite these efforts, however, the post-Civil War drive for racial equality failed and blacks were subjected to a new system of involuntary servitude.³⁴ According to William Cohen,

28. See Franklin, *The Enforcement of the Civil Rights Act of 1875*, 6 *Prologue* 225 (1974).

29. See Gerber, *Lynching and Law and Order: Origin and Passage of the Ohio Anti-Lynching Law of 1896*, 83 *Ohio Hist.* 33 (1974).

30. See Somers, *Black and White in New Orleans: A Study in Urban Race Relations, 1865-1900*, 40 *J. So. Hist.* 19, 35-38 (1974).

31. *Id.* at 30.

32. See Howard, *The Black Testimony Controversy in Kentucky, 1866-1872*, 58 *J. Negro Hist.* 140 (1973).

33. *Id.* at 157.

34. See Cohen, *Negro Involuntary Servitude in the South, 1865-1940: A Preliminary Analysis*, 42 *J. So. Hist.* 31 (1976).

Far less rigid than slavery, the system of involuntary servitude that emerged after the Civil War was a fluid, flexible affair which alternated between free and forced labor in time to the rhythm of the southern labor market. Employers had the legal and social tools to compel labor from blacks, but the use of such measures was not obligatory. When labor was plentiful, Draconian powers were unneeded. When it was scarce, they were readily at hand. Thus, whites had no reason to impede black mobility except when faced with a real or anticipated shortage of hands, and the system had something of a "now you see it, now you don't" quality about it. Still, compulsion was frequent enough. Even when unused, force posed an omnipresent threat which had a pervasive effect upon the tone of the southern labor system.³⁵

While several of these factually oriented articles are important, none of them is different in kind from the sort of literature that was being published a decade ago. The book which perhaps best illustrates the similarity of recent factually oriented writing to earlier writing is Carl B. Swisher's *The Taney Period, 1836-64*.³⁶ This volume, like the two earlier volumes in the Oliver Wendell Holmes Devise *History of the Supreme Court of the United States*,³⁷ is encyclopedic in its research and in its coverage of topics, but, unfortunately, does little to illuminate the significance of the past. Swisher's *The Taney Period, 1836-64*, in short, is a book that is vital as a reference source for anyone who needs information about the mid-nineteenth century Supreme Court; like most of the writing of a decade ago, it is not a book that one would examine for its ideas.

Also similar to the literature of ten years ago are most of the articles surveying such matters as the methodology of legal history,³⁸ available source materials,³⁹ or the existing literature.⁴⁰ One such article, which summarizes the legal source materials that have been microfilmed by the Mormon Genealogical Society, is quite important

35. Id. at 33.

36. C. Swisher, *The Taney Period, 1836-64* (1974).

37. See C. Fairman, *Reconstruction and Reunion, 1864-88, Part One* (1971); J. Goebel, *Antecedents and Beginnings to 1801* (1971).

38. See, e.g., Parker, *The Masochism of the Legal Historian*, 24 U. Toronto L.J. 279 (1974); Zobel, *The Joys and Uses of Legal History*, 84 Mass. Hist. Soc'y Proc. 53 (1972).

39. See, e.g., Main, *Probate Records As a Source for Early American History*, 32 Wm. & Mary Q. 89 (3d ser. 1975); Smith, *Underregistration and Bias in Probate Records: An Analysis of Data from Eighteenth-Century Hingham, Massachusetts*, 32 Wm. & Mary Q. 100 (3d ser. 1975).

40. See Holt, *Now and Then: The Uncertain State of Nineteenth-Century American Legal History*, 7 Ind. L. Rev. 615 (1974); Winitsky, Roger B. Taney: A Historiographical Inquiry, 69 Md. Hist. Mag. 1 (1974).

since it indicates how historians may obtain access to the film and even gives the hours during which various Mormon libraries are open and the means by which film may be purchased.⁴¹ While articles of this sort offer promise for the future development of the field of legal history, they are not in themselves indications that important developments have already begun to occur.

Professionalization of Legal History.—In fact, significant changes have begun to occur in the field of American legal history as a result of increasing professionalization. Professionalization is most visible, perhaps, in the pages of the *American Journal of Legal History*, in which many articles ten years ago were addressed not to academic legal historians but to practicing attorneys. In the last two years, however, the *Journal* has become a publication in which academic historians speak to each other. Since virtually every one of the many articles in the *Journal* has become essential reading for those wishing to keep current in the field, I have not included them in this review. The professionalization of the *Journal* has not been a unique development, but has been paralleled by the creation of a legal history series by the Harvard University Press—a series which has published two monographs in the past two years.⁴² The appearance of a professionally oriented body of literature is a central element in the emergence of any genuine profession.⁴³

Signs of professionalization can also be seen in the methodological literature of the past two years. Several methodological articles make a point, not generally accepted when I made it in these pages ten years ago,⁴⁴ that we cannot resolve current legal questions by asking how the past intended us to resolve them when the past never asked the question which concerns us and therefore left no answer.⁴⁵ William Wiecek recognizes the power of this truism in his book *The Guarantee Clause of the U.S. Constitution*.⁴⁶ Wiecek devotes relatively few pages to an analysis of the intentions of the Constitution's framers, but instead concentrates on how the Guarantee Clause has evolved over time.

41. Gerlach & Nicholls, *The Mormon Genealogical Society and Research Opportunities in Early American History*, 32 Wm. & Mary Q. 625 (3d ser. 1975).

42. See G. Dargo, *Jefferson's Louisiana: Politics and the Clash of Legal Traditions* (1975); W. Nelson, *Americanization of the Common Law: The Impact of Legal Change on Massachusetts Society, 1760-1830* (1975).

43. See T. Kuhn, *The Structure of Scientific Revolutions* 19-21 (2d ed. 1970).

44. See Nelson, *supra* note 1, at 695.

45. See Kaczorowski, *Searching for the Intent of the Framers of the Fourteenth Amendment*, 5 Conn. L. Rev. 368 (1972-73); Miller, *An Inquiry into the Relevance of the Intentions of the Founding Fathers, with Special Emphasis Upon the Doctrine of Separation of Powers*, 27 Ark. L. Rev. 583 (1973).

46. W. Wiecek, *The Guarantee Clause of the U.S. Constitution* (1972).

Those articles which do seek to examine "the original intent"⁴⁷—and they are far fewer in number than they were a decade ago—do so with considerable sensitivity and with an explicit recognition of the limits of their analysis. Charles Wolfram, for example, in an excellent article on "The Constitutional History of the Seventh Amendment,"⁴⁸ recognizes that we cannot answer with certainty whether the framers intended juries always to be unanimous bodies of twelve men, but argues that we can be quite certain that "[j]uries were sought to be thrust into cases to effect a result different from that likely to be obtained by an honest judge sitting without a jury."⁴⁹ Similarly Charles Lofgren, while recognizing that "the original understanding"⁵⁰ cannot always bind the present, maintains that the founding fathers expected that compulsory military service would be required only in the militia and purposely provided the federal government with sufficient means of raising revenue so that it could recruit the regular army voluntarily and thereby avoid conscription. Finally, Arthur Bestor quite rightly concludes that the Constitution's framers did not believe in a rigid application of the doctrine of separation of powers, but instead intended to have the branches of government checking and balancing each other by participating in various governmental functions.⁵¹ What is implicit even in the articles that do search for original intent is an assumption that the past was not the same as the present, that people in the past did not see issues in the same light as we do in the present, and hence that the past can never yield precise, binding answers to the problems of the present.

This assumption about the essential difference between the past and the present is, of course, axiomatic for practicing historians, who generally seek not to instruct us about the answers to present problems but to explain the processes of historical evolution and the reasons for particular historical changes. Legal historians have begun to do the same. In *Jefferson's Louisiana: Politics and the Clash of Legal Traditions*,⁵² George Dargo traces the evolution of American law and government in Louisiana during the first decade of the nineteenth century. Dargo explains that the American takeover of Louisiana in 1803 led to a conscious attempt to impose American culture and law on the area in

47. Bestor, *Separation of Powers in the Domain of Foreign Affairs: The Original Intent of the Constitution Historically Examined*, 5 *Seton Hall L. Rev.* 527 (1974).

48. Wolfram, *The Constitutional History of the Seventh Amendment*, 57 *Minn. L. Rev.* 639 (1973).

49. *Id.* at 653.

50. Lofgren, *Compulsory Military Service under the Constitution: The Original Understanding*, 33 *Wm. & Mary Q.* 61 (3d ser. 1976).

51. See Bestor, *supra* note 47.

52. See G. Dargo, *supra* note 42.

order to replace the indigenous Franco-Spanish system. When many American newcomers in Louisiana sympathized with the Burr Conspiracy in 1805-07, however, the territorial administration forged an alliance with the old French settlers; Louisiana's adherence to the civil law is a product of that alliance.

In another book, *Free Men All: The Personal Liberty Laws of the North, 1780-1861*,⁵³ Thomas Morris brilliantly traces the gradual polarization of ideological positions in the mid-nineteenth century on the issue of fugitive slaves, with the result that room for compromise between North and South became increasingly limited. In his study of sexual morality and social control, David Pivar argues that a basic transformation in American attitudes toward power occurred between the late eighteenth and late nineteenth century.⁵⁴ He notes that the framers of American constitutions in the late eighteenth century harbored a healthy fear of all governmental power and sought to restrain its use. By the end of the nineteenth century, however, Americans were willing to use power as long as it was directed to the attainment of legitimate social goals. His argument suggests that restraints were imposed on governmental economic intervention in the late 19th century not because of any fear of governmental power in general, but because of a fear that power would be used for illegitimate ends, such as taking property from one individual and giving it to another. When government could intervene in the economy without redistributing wealth, however, its intervention was tolerated.

There are also some noteworthy articles which seek to explain important historical changes. One, which traces Indian-white legal relations in seventeenth century Plymouth, notes that in the 1620's Indians were treated fairly and punished equally to whites even though ethnocentric English attitudes required that English courts resolve disputes between English settlers and Indians.⁵⁵ After King Philip's War, however, many Indians were enslaved and "considerations of protection for Indian rights were ignored."⁵⁶ In another article, one of the best of the last two years, Lance Banning asks the important question why the federal constitution, to which so much opposition existed in 1787-1789, gained such quick acceptance that by the early 1790's opposition had largely

53. T. Morris, *Free Men All: The Personal Liberty Laws of the North, 1780-1861* (1974).

54. D. Pivar, *Purity Crusade: Sexual Morality and Social Control, 1868-1900* (1973).

55. Ronda, *Red and White at the Bench: Indians and the Law in Plymouth Colony, 1620-1691*, 110 *Essex Inst. Hist. Coll.* 200 (1974).

56. *Id.* at 213.

disappeared.⁵⁷ Banning's answer rests upon his claim that a main element of eighteenth century thought was the fear of constitutional degeneration—a fear which resulted in an instinctive unwillingness to alter constitutional provisions once they had been written. Among the signs of corruption and degeneration to which the eighteenth century was attuned were an ambitious executive, a standing army, rising taxes, public debts, and chartered corporations. Republicans saw in Hamilton's program, which contained all these measures together with the broad construction and the social elitism of Hamiltonian Federalists, the beginnings of constitutional subversion:

But opposition to the progress of social and political corruption traditionally required an ancient constitution against which it could measure the degeneration of the present day. A critique of constitutional corruption needed an accepted constitution that could be seen to undergo a process of decay. . . . Paradoxically, then, it was the appearance of a deeply felt opposition to the policies of our first administration which assured the quick acceptance of the Constitution. . . .⁵⁸

Another sign of increasing professionalization among legal historians is the recognition by recent writers of one of the special powers of historical analysis—the capacity of a good historian to place two seemingly discrete events in juxtaposition and thereby understand both events more fully. Few legal historians engaged in this process of juxtaposition a decade ago, but many have in the past two years. Robert Stevens, for example, has urged that legal developments in the United States can often be better understood if they are viewed in juxtaposition with developments in England.⁵⁹ In particular, he notes that anti-lawyer sentiment in early Massachusetts was little different from anti-lawyer sentiment in Civil War England and that changes in post-Civil War England and changes in post-Revolutionary American law were part of a broader late eighteenth and early nineteenth century process of modernization of the common law. George Haskins,⁶⁰ agreeing with Stevens, has argued that Massachusetts did not become a Bible Commonwealth because

57. Banning, *Republican Ideology and the Triumph of the Constitution, 1789 to 1793*, 31 *Wm. & Mary Q.* 167 (3d ser. 1974).

58. *Id.* at 187.

59. See Stevens, *Unexplored Avenues in Comparative Anglo-American Legal History*, 48 *Tulane L. Rev.* 1086 (1974).

60. See Haskins, *Representative Government and the "Bible Commonwealth" in Early Massachusetts*, 9 *Akron L. Rev.* 207 (1975).

[the settlers] remained, in their respective circumstances and backgrounds, Englishmen of their time. They brought with them outlooks and social attitudes which not only reflected contemporary England but much of the legacy and humanism of the Renaissance. Thus, except insofar as their daily life and intellectual tastes were affected by Puritan principles, and their institutions necessarily molded by the same driving concerns for which the colonial enterprise had been undertaken, they remained basically English in their outlooks, habits and understanding.⁶¹

Employing similar comparative modes of analysis, Scott Powe has urged that the activist role pursued by the Supreme Court from the 1890's to the 1930's under the rubric of due process can be properly understood only against the background of the Court's earlier activist role in some two hundred municipal bond cases decided between 1865 and 1890;⁶² Russell Wheeler has concluded that the rejection by early federal judges of the English and colonial model permitting judges to perform a wide variety of extrajudicial functions can be understood only in conjunction with the simultaneous development of the ideal of the rule of law;⁶³ Jonathan Lurie has maintained that nineteenth century private commodities exchanges can be usefully analyzed as legal analogues of twentieth century administrative agencies;⁶⁴ and Milton Klein has suggested that the role of lawyers in the coming of the American Revolution was parallel to the role which Arthur Schlesinger, Sr. thought was played by merchants.⁶⁵

The two items that use the process of juxtaposition to reach the most interesting conclusions are a book on witchcraft in Salem and an article on the jurisprudence of Justice Holmes. In *Salem Possessed: The Social Origins of Witchcraft*,⁶⁶ Paul Boyer and Stephen Nissenbaum seek to explain how the terror of witchcraft in Salem occurred. They relate it to the breakdown of a theocratically oriented society which was trying to maintain itself against the onslaught of liberal capitalism. Their position is that the farmers of Salem Village were seeking to main-

61. Id. at 216.

62. Powe, Rehearsal for Substantive Due Process: The Municipal Bond Cases, 53 Texas L. Rev. 738 (1975).

63. Wheeler, Extrajudicial Activities of the Early Supreme Court, [1973] Sup. Ct. Rev. 123.

64. Lurie, Commodities Exchanges as Self-Regulating Organizations in the Late 19th Century: Some Perimeters in the History of American Administrative Law, 28 Rutgers L. Rev. 1107 (1975).

65. See Klein, New York Lawyers and the Coming of the American Revolution, 55 N.Y. Hist. 383 (1974).

66. P. Boyer & S. Nissenbaum, *Salem Possessed: The Social Origins of Witchcraft* (1974).

tain a sort of utopian community safe from the pollutions of the material world—pollutions which, like all other sin, were both evil and attractive. The farmers reacted to liberal capitalism by viewing it the same way they viewed other sin, and they punished those committing the sin with the extreme punishment of death. Only when the sin failed to go away did the villagers cease their attempt to construct a heaven on earth, turn to the next world for their solace, and thereby permit a liberal legal order to emerge in this world.

Likewise, the author of a student note, "Holmes, Peirce and Legal Pragmatism,"⁶⁷ in searching for the source of Holmes's "theory of external legal standards"⁶⁸ and his "attack, implicit throughout *The Common Law*, on the notion that private, internal standards can serve as a basis of legal liability,"⁶⁹ turns to the philosophy of Charles Peirce, a close associate of Holmes in the late 1860's. The note maintains that "Holmes's recognition that only public standards can function as legal rules is paralleled in Charles Peirce's attack on the epistemology of Rene Descartes."⁷⁰ The author continues that "Peirce sought to replace Descartes's reliance on the 'natural light' of immediate intuition of clear and distinct ideas with the process of a community of inquirers reaching agreement through application of public and accepted methods of research."⁷¹ This juxtaposition of Holmes and Peirce is especially important for what it suggests about a more general inquiry into post-Civil War historiography—an inquiry into the reasons for the rejection throughout American society of private moral intuitions as standards of conduct.⁷²

Legal History as Philosophy.—As the literature reviewed in the past several paragraphs suggests, the growing professionalization in the field of American legal history is extremely valuable for the new insights it can yield into the nature of our legal past. Yet professionalization can also have its costs, one of which can be the withdrawal of history and its practitioners from the needs and concerns of the society in which we live today. Fortunately, however, at least some legal historians are not withdrawing into purely academic areas, but are instead directing their research and writing toward important current questions. These legal

67. Note, Holmes, Peirce and Legal Pragmatism, 84 Yale L.J. 1123 (1975).

68. Id. at 1129.

69. Id.

70. Id. at 1130.

71. Id. at 1131.

72. See Nelson, Officeholding and Powerwielding: An Analysis of the Relationship Between Structure and Style in American Administrative History, 10 L. & Soc'y Rev. 187, 220-31 (1976); Nelson, The Impact of the Antislavery Movement Upon Styles of Judicial Reasoning in Nineteenth Century America, 87 Harv. L. Rev. 513, 547-66 (1974).

historians are attempting to write history as a form of political philosophy.

Two broad groups of philosophically oriented historians can be identified within the writing of the past two years. The first group consists of several radical critics of the existing legal order who attempt to show that the existing structure of legal thought and legal doctrine has or necessarily must oppress the weak and the poor. Jerold Auerbach, for example, has written a highly political essay in Alan Reitman's book, *The Pulse of Freedom*.⁷³ Auerbach's essay, entitled "The Depression Decade,"⁷⁴ argues that "the prototypical Depression victim of civil liberties infractions was an industrial worker, a union organizer, or a radical critic of capitalism."⁷⁵ This approach, however, is an unduly narrow one. While labor made an important contribution to civil liberties in the 1930's, one cannot ignore the contribution of other groups such as artists and blacks simply because such groups do not readily fit into a Marxist view of history. Auerbach's political view of history is, in short, distorted.

Similarly, Mary Berry⁷⁶ tries to argue that since federal power has often been used to repress blacks, the Constitution was formulated for the purpose of repression. She labels American constitutional law as "a handy philosophical tool for maintaining white superiority,"⁷⁷ since it is based on "essentially racist, not legal, concerns."⁷⁸ Unfortunately, Professor Berry has exaggerated her argument, failing to separate out historical cause from historical consequence.

Far more sophisticated are the writings of Morton Horwitz and Joel Brenner. In his outstanding essay, "The Historical Foundations of Modern Contract Law,"⁷⁹ Horwitz's main theme is that the modern "will theory of contract,"⁸⁰ which arose in the late eighteenth and early nineteenth century, necessarily favors capitalist entrepreneurs at the expense of the weak, the unsophisticated and the poor. To the extent that Horwitz limits his analysis to a discussion of the effects of the will theory, the position is a plausible one, for our modern experience suggests that the doctrine of freedom of contract does benefit the strong at the expense of the weak. Unfortunately, he occasionally weakens his thesis by arguing that contract law was purposely formulated to produce

73. A. Reitman, *supra* note 5.

74. Auerbach, *The Depression Decade*, in A. Reitman, *supra* note 5, at 65.

75. *Id.*

76. See M. Berry, *supra* note 27.

77. *Id.* at 1.

78. *Id.* at ix.

79. Horwitz, *The Historical Foundations of Modern Contract Law*, 87 *Harv. L. Rev.* 917 (1974).

80. *Id.* at 936.

repressive results. This claim is much less plausible in view of the social fragmentation or mobility that existed in early nineteenth century America. That fragmentation and mobility, coupled with contemporary awareness of those phenomena, would have made it difficult for members of the small elite that Horwitz believes to have benefited from a will theory of contract to have identified each other and conspired to put that theory into practice. Nonetheless, Horwitz's article, which is part of a forthcoming book, is a powerful and important attempt to understand nineteenth century legal development from a viewpoint that is relevant to current legal concerns.

A not dissimilar article by Joel Brenner on "Nuisance Law and the Industrial Revolution"⁸¹ asks why the common law of nuisance did not stand in the path of industrial development in nineteenth century England. Unfortunately, however, Brenner makes inconsistent claims in his attempt to decide whether judges who were seeking to promote the interests of the entrepreneurial class consciously changed nuisance law to attain that end or whether the structure of nuisance law itself, which had always "had a zoning function . . . of allocating activities to appropriate areas,"⁸² merely permitted the development of industrial zones once the economy placed a demand on society for them.

Robert Cover, like Horwitz and Brenner, also makes use of history to address current questions about the apparently repressive nature of law. The central object of his book, *Justice Accused: Antislavery and the Judicial Process*,⁸³ is to explain how judges were able to reject moral claims for freedom that were advanced on the part of slaves between the revolution and the Civil War. Much of the book consists of an analysis of the formal assumptions of the judiciary—primarily the assumption that judges ought not to engage in lawmaking as an act of will—and of the moral underpinnings of those assumptions. Cover thereby shows that the choices which judges confronted in slavery cases, like most judicial choices, involved a complex conflict of competing moralities. In effect, Cover, like Auerbach, Berry, Horwitz and Brenner, is studying how instruments of oppression grow out of law which is designed as a rational tool for the attainment of desired social ends. Unlike the others, however, he recognizes that law often oppresses some in the interest of the good of others.

Two older historians—Grant Gilmore and Willard Hurst—write from a different, but equally powerful perspective. Essentially, Gilmore

81. Brenner, *Nuisance Law and the Industrial Revolution*, 3 J. Legal Studies 403 (1974).

82. *Id.* at 406.

83. R. Cover, *Justice Accused: Antislavery and the Judicial Process* (1975).

and Hurst reject the idea that law can be rationally designed to accomplish any end. In a recent lecture, "Thoreau, Conscience and Law,"⁸⁴ Hurst made the argument that law should never be understood as a rational process of moral choice but must be viewed instead as a process of compromising conflicting social interests. He does not appear to have found American law repressive in the past, at least when it has been made in a democratic legislative process. Since Hurst sees hope only in democratic lawmaking, he urges that the duty of the courts must be the improvement of the legislative processes through mechanisms such as reapportionment and the encouragement of free expression and association and not the articulation of fixed, morally derived doctrine.

Similarly, Grant Gilmore in a recent lecture, "The Age of Anxiety,"⁸⁵ argues "that it is not possible to make a scientific statement about . . . law,"⁸⁶ because "law is always an instinctive response to disorder, never a reasoned approach to the quite different problem of achieving order."⁸⁷ Gilmore's attitude also leads to the conclusion that we will get our best results by leaving lawmaking to the political process rather than in the hands of professionals striving to develop a scientific statement of the law.

An article on late nineteenth century railroad regulation⁸⁸ leads me, at least, to be wary of law that is hammered out in the political process. Its author, Albro Martin, summarizes recent work on railroad regulation and concludes that the Interstate Commerce Act of 1887 advanced no rational program of regulation and served little real purpose. He writes:

What the nation required in 1887 was a body which could proceed to cartelize the railroads; but the acts of 1887 and 1890 were a bundle of contradictory compromises which prohibited every kind of concerted action the railroads had tried up to that time. In determining the outcome of the bumbling efforts to establish meaningful federal regulation, the practical desire for a stable rate structure was less important than the deep-seated mistrust, hatred, and fear of large, insulated aggregations of power. This attitude has always rested at the heart of American egalitarianism A new kind of power, in many ways more pervasive than political power, had emerged by the 1870s. If they could prevent it, Americans were not going to allow great concentrations

84. Hurst, *Thoreau, Conscience and Law*, 19 S.D.L. Rev. 1 (1974).

85. Gilmore, *The Storrs Lectures: The Age of Anxiety*, 84 Yale L.J. 1022 (1975).

86. *Id.* at 1041.

87. *Id.* at 1044.

88. Martin, *The Troubled Subject of Railroad Regulation in the Gilded Age: A Reappraisal*, 61 J. Am. Hist. 339 (1974).

of economic power to continue [T]he people certainly were not going to lend the support of the state to the creation and perpetuation of such power Most Americans who had to deal with the railroad problem knew the price, in dollars and cents, of a continuation of destructive competition, but they were willing, in fact insisted on being allowed, to pay the price. Railroad men themselves sensed this opposition and some, like the testy A. B. Stickney, opposed pooling

Even so, railroads were "cartelized." Consolidation, which railroad men had warned against throughout the last third of the nineteenth century, was the inevitable alternative to pooling. It became a reality by the first decade of the twentieth century. By 1906 the major railroads were neatly packaged into some six or seven systems. This process had begun in earnest with the passage of the Act of 1887⁸⁹

Martin's study of railroad regulation makes it plain, in short, that Americans must engage in rational legal ordering to avoid legal chaos and social waste. In returning to rationality, we must, of course, keep in mind the writings of critics such as Robert Cover and Morton Horwitz, who properly remind us of the repressive effects that rational legal schemes can have. But their emphasis upon the occasional repressive effects of the law must not cause us to ignore the law's accomplishments over the long course of American history. Although the few legal historians who have abandoned purely professional concerns and evaluated our legal traditions during the past two years have been rather critical of them, their critical approach is not an inevitable one. History can also fulfill the function of identifying the legal traditions that we still value and linking them with the social conditions that underlie them. In the coming years, perhaps, legal history will begin to do so.

89. *Id.* at 370-71.

SECURITIES REGULATION

RICHARD D. KATCHER

I

DEFINITION OF A SECURITY

The Forman Case.—This year's survey of securities regulation begins with the evolving definition of the term "security" under the federal securities laws.¹ The only Supreme Court decision in this area during the last two years was *United Housing Foundation, Inc. v. Forman*.²

The question in *Forman* was whether the "stock" purchased by residents of the New York City middle income housing project known as Co-Op City was a security within the meaning of the Securities Act of 1933 (Securities Act or 1933 Act) and the Securities Exchange Act of 1934 (Exchange Act or 1934 Act).³ Residents of Co-Op City were required to purchase stock in the operating company. The stock could not be pledged or otherwise encumbered, and, since it was nontransferable except to a surviving spouse or to an eligible purchaser of the apartment, when a tenant desired to leave, he was required to resell his stock to the operating company. Alternatively, if the operating company declined to purchase, the sale had to be made to the eligible tenant. In either case,

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Richard D. Katcher is a member of the New York Bar.

1. Section 3 (a) (10) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (1970), provides:

The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

Section 2(3) of the Securities Act of 1933, 15 U.S.C. § 77b(1) (1970), contains a similar definition. The Supreme Court has held the definitions to be interchangeable. *Tcherepnin v. Knight*, 389 U.S. 332, 335-36 (1967). See also the definitions of "security" in § 2(a)(16) of the Public Utility Holding Company Act of 1935, 15 U.S.C. § 79b(a)(16) (1970) and § 202(a)(18) of the Investment Advisors Act of 1940, 15 U.S.C. § 80b-2(a)(18) (1970) and § 2a(36) of the Investment Company Act of 1940, 15 U.S.C. § 80a-2(a)(36) (1970).

2. 421 U.S. 837 (1975).

3. 15 U.S.C. §§ 77b(1), 78c(a)(10) (1970). See note 1 *supra*.

the required price was the \$25 per share initially paid by the departing tenant.⁴ Accordingly, an owner could not profit from sale of his stock. The stock had no voting rights—each apartment had one vote. Rental payments were used to pay interest and principal on the mortgage and to pay operating expenses of the project. The project also provided washing machines and parking facilities for its tenants and leased professional offices and commercial facilities.⁵

The plaintiffs brought suit under section 17 (a) of the 1933 Act⁶ and section 10 (b) of the 1934 Act,⁷ alleging that the information bulletin on which they relied in purchasing their apartments was false and misleading. The bulletin stated that the contractor would bear construction costs above a certain amount, and the tenants alleged that they were being charged for these costs by way of increased rental charges.

The United States District Court for the Southern District of New York dismissed the complaint,⁸ holding that the use of the term "stock" with reference to the shares did not make them securities under the federal securities laws. Relying on the Supreme Court opinions in *Securities & Exchange Commission v. W.J. Howey Co.*,⁹ and *Securities & Exchange Commission v. Joiner Leasing Corp.*,¹⁰ the court specifically found that the shares were not "investment contracts" within the statutory definition.¹¹ The Second Circuit reversed¹² and held that since the shares were called "stock," they were covered by the federal securities laws.¹³ That court, also relying on *Howey*, found the shares to be "investment contracts" since the plaintiffs had invested money in a common enterprise with an expectation of profit.¹⁴ The Second Circuit identified three elements of profit. First, because of the presence of commercial facilities, the tenants paid less rent than they would have absent such facilities. Second, the court found the tax deduction afforded the tenants by means of the interest payment on the mortgage was profit. Finally, plaintiffs actually realized profit since their subsidized housing was cheaper than comparable unsubsidized housing.¹⁵

4. If the tenant sold to another eligible tenant, the seller could in addition recoup a fraction of the mortgage paid-off through his rental payments. 421 U.S. at 842-43.

5. *Id.* at 855-56.

6. 15 U.S.C. § 77q(a) (1970).

7. *Id.* § 78j(b); and rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 (1975).

8. 366 F. Supp. 1117 (S.D.N.Y. 1973).

9. 328 U.S. 293 (1946).

10. 320 U.S. 344 (1943).

11. 366 F. Supp. at 1128. See text of definition in note 1 *supra*.

12. 500 F.2d 1246 (2d Cir. 1974), *rev'd*, 421 U.S. 837 (1975).

13. *Id.* at 1252. See note 1 *supra*.

14. 500 F.2d at 1253-54.

15. *Id.* at 1254-55.

Applying an economic reality test, the Supreme Court reversed.¹⁶ The Court held that the mere fact that a share is called "stock" does not bring it within the statutory definition of a security.¹⁷ Citing the House Report accompanying the 1933 Act,¹⁸ the Court found that the Co-Op City stock lacked the characteristics that "in our commercial world fall within the ordinary concept of a security."¹⁹ The shares paid no dividends and had none of the other characteristics generally associated with stock. They were not negotiable, could not be pledged, had no voting rights in proportion to the amount owned, and could not appreciate in value. In short, the inducement to purchase this stock was to acquire subsidized housing and not to make a profit.²⁰

Rejecting the position of the Second Circuit, the Court also held that the stock was not an investment contract since the plaintiffs did not expect to receive profits, at least in the traditional sense. "Profits" was found to mean either earnings resulting from the use of the investors' funds or capital appreciation resulting from the development of the initial investment.²¹ The income tax advantage was not income or profits since, according to the Court, such benefits are available to any homeowner paying mortgage interest. Similarly, the fact that subsidized housing may be cheaper than comparable unsubsidized housing did not result in profits since it has nothing to do with managerial efforts.²² Finally, the Court stated that the expectation of profits required by the statutory definition must be more than an insignificant one, holding that any income from the commercial and other facilities was "too speculative and insubstantial to bring the entire transaction within the Securities Acts."²³

The *Forman* opinion also indicated that the manner in which a share is offered may bear on whether it is a security within the statutes. The Court noted that the information bulletin distributed to potential Co-Op City tenants emphasized the advantages of cooperative living, not the ability to profit upon resale of an apartment.²⁴ Indeed, the Court gave weight to the fact that the bulletin emphasized the nonprofit nature of the transaction and did not mention the provision of commercial facilities.²⁵ The analysis implies that when a buyer is drawn by

16. 421 U.S. at 847.

17. *Id.* at 848.

18. H.R. Rep. No. 85, 73d Cong., 1st Sess. 11 (1933).

19. 421 U.S. at 851.

20. *Id.*

21. *Id.* at 851-52.

22. *Id.* at 855.

23. *Id.* at 856 & n.21. The Court found the facilities were present not for potential profits, but in order to make essential services available to the tenants. *Id.*

24. *Id.* at 853-54.

25. *Id.* at 854, 856.

a desire to use or consume the item purchased, the securities laws are inapplicable to the transaction.²⁶ As a result, the *Forman* opinion raises but does not decide the more difficult issue of whether the traditional cooperative apartment investment is subject to the securities laws.²⁷

Other Developments: Investment Contracts.—A recent decision of major significance on the subject of investment contracts is *Daniel v. International Brotherhood of Teamsters*,²⁸ where a district court held that the antifraud provisions of the federal securities laws apply to a compulsory, noncontributory union pension plan. The plaintiff, who was denied retirement benefits, alleged that the union in violation of both securities acts had misrepresented conditions on his receipt of benefits.²⁹ The court rejected the historical position of the Securities and Exchange Commission (SEC) that a compulsory, noncontributory plan does not involve the sale of a security and held that the employee had purchased an investment contract within the statutory definition of security.³⁰ The court found a voluntary sale in the diversion of a portion of the employees' wages to the plan since the employees were required to vote in favor of such diversion as part of the union contract. The anticipated retirement benefits constituted the required expectation of profits since the estimated total of the payout exceeded the contributions. Finally, in recognition of the "risk capital" test, the court also noted that the plan ultimately may be unable to fund the benefits, and therefore the employee assumed some risk.³¹

In the area of investment contracts covered by the statutory definitions of securities, the "managerial efforts" test has received further treatment in a number of specific contexts. Generally, the test provides that if the seller or promoter in a transaction provides managerial services upon which the investor relies, an investment contract within the securities laws is created.³² For example, in three no action positions

26. See *id.* at 852-53.

27. See *id.* at 859 n.26. The *Forman* Court did acknowledge the so-called "risk capital" test (see *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 369 P.2d 960, 13 Cal. Rptr. 186 (1961)), but declined to express an opinion on it. The Court stated that were it inclined to accept the test, the required risk would necessarily be a risk of fluctuating value traditionally associated with securities investments. 421 U.S. at 857 n.24. See also *Grenader v. Spitz*, [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,523 (2d Cir. April 28, 1976), petition for cert. filed, 376 BNA Sec. Reg. & L. Rep. A-11 (Oct. 18, 1976) (No. 76-541) (sale of stock in cooperative apartment not a sale of a security within securities laws).

28. 410 F. Supp. 541 (N.D. Ill. 1976).

29. *Id.* at 543-44.

30. *Id.* at 552-53. For text of the statutory definition, see note 1 *supra*.

31. 410 F. Supp. at 550-51. See note 27 *supra*. See generally Mundheim & Henderson, *Applicability of the Federal Securities Laws to Pension and Profit Sharing Plans*, 29 Law & Contemp. Prob. 795 (1964).

32. See, e.g., *SEC v. American Inst. Counselors, Inc.*, [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,388 (D.D.C. 1975); *Jenson v. Continental Fin. Corp.*, 401

with respect to the sale of gold,³³ the SEC staff position is that it will not consider an investment contract created if the seller or promoter does not provide essential managerial efforts upon which the investor must rely to make a profit.³⁴ In order to avoid a finding of an investment contract, the sale must be for cash and not on margin, the depository arrangements must be limited to providing insurance and a receipt entitling the purchaser to take possession of the gold, and the seller or the promoter must not be obligated to repurchase the gold or sell it for the account of the investor.³⁵

The managerial efforts criterion has also been important to decisions involving discretionary commodity futures contracts trading accounts. If a broker has control over the account or if the investor relies on the broker for investment decisions, an investment contract will be created even though the account may not be denominated a discretionary account. This position was upheld in *Scheer v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*³⁶ where the court held an account to be a discretionary account by reason of the manner in which it was operated. In *Rochkind v. Reynolds Securities, Inc.*,³⁷ the court held that a pooling of accounts is not a prerequisite to finding an investment contract—the only element necessary to an investment contract in this regard is that the investor's fate be intertwined with the promoter's.³⁸ If the investor is more than tangentially involved in the investment decisions, however, there is no investment contract. In *Baker v. H.S. Kipnis & Co.*³⁹ and

F. Supp. 792 (D. Minn. 1975); SEC v. Western Pac. Gold & Silver Exch. Corp., [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,064 (D. Nev. 1975). See also SEC v. Glenn W. Turner, Inc., 474 F.2d 476, 481-83 (9th Cir.), cert. denied, 414 U.S. 821 (1973).

33. SEC Securities Exchange Act Release No. 11,156 (Dec. 26, 1974). The restrictions on private ownership of gold by United States citizens were removed effective December, 1974.

34. Id. See SEC v. Glenn W. Turner, Inc., 474 F.2d 476, 481-83 (9th Cir.), cert. denied, 414 U.S. 821 (1973).

35. SEC Securities Exchange Act Release No. 11,156 (Dec. 26, 1974). In a later letter, the staff did not object to a seller publicly indicating its view on the advisability of a gold investment. Deak & Co., [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 80,395 (SEC Oct. 3, 1975). If the seller advises at what price to purchase or sell, a question may arise whether such services represent managerial efforts essential to the ability to make a profit. See, e.g., Investment Rarities, Inc., [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 80,235 (SEC June 3, 1975). See also SEC v. Brigadoon Scotch Distrib. Ltd., 388 F. Supp. 1288 (S.D.N.Y. 1975) (finding investment contract in sale of coin portfolios because of promoter's management input).

36. [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,086 (S.D.N.Y. 1975). There is still a split among the federal circuits on whether a discretionary commodity futures contract account is a security. See Glazer v. National Commodity Research & Statistical Serv., Inc., 388 F. Supp. 1341 (N.D. Ill. 1974).

37. 388 F. Supp. 254 (D. Md. 1975).

38. Id. at 257. See also A.G. Edwards & Sons, [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 80,153 (SEC Mar. 28, 1975).

39. [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,349 (N.D. Cal. 1975).

Bartley v. P.G. Commodities Associates, Inc.,⁴⁰ the courts refused to find investment contracts in the face of evidence that the plaintiffs participated in the investment decisions with the defendants.⁴¹

In the area of real estate developments, there were two decisions in 1975 which held investments in real estate not to be securities. In both *Davis v. Rio Rancho Estates, Inc.*⁴² and *Happy Investment Group v. Lakeworld Properties, Inc.*⁴³ the courts found that land was offered as a residential development rather than an investment, and that while the developer may have provided roads and other improvements, these were not essential "managerial" services. In neither case did the developer enter into a management contract or promise to operate the project and distribute profits, nor did the developer obligate himself to create a thriving community. Essentially, the courts refused to convert land sales to securities in the absence of some common enterprise. In *Cook v. Farrell*,⁴⁴ however, the court held that an investment contract was created where investors purchased land and gave the seller a power of attorney to operate the land.⁴⁵

Another area which witnessed development in the past year concerns large denomination investments which are divided and redistributed. The question which frequently arises is whether the participation interests are securities. In *National Association of Securities Dealers, Inc.*,⁴⁶ the SEC staff took the position that the pooling by brokers of customers' funds to acquire interests in institutional loans created a security. In *Prudential-American Securities, Inc.*,⁴⁷ however, the staff took the position, presumably because of the individualized nature of the transaction, that the purchase of a banker's acceptance from a bank by a broker for the accounts of four customers does not create a security under the Investment Company Act of 1940. The bank's confirmations reflected the names of the customers, and their percentage interests.⁴⁸

Finally, three recent cases make it clear that a limited partnership

40. Id. ¶ 95,394 (S.D.N.Y. 1975).

41. See also *A.B.A. Auto Lease Corp. v. Adam Indus., Inc.*, 387 F. Supp. 531 (E.D. Pa. 1975) (franchisees' efforts preclude a finding of an investment contract).

42. 401 F. Supp. 1045 (S.D.N.Y. 1975).

43. 396 F. Supp. 175 (N.D. Cal. 1975).

44. [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,337 (N.D. Ga. 1975).

45. See rule 3a 12-5, 17 C.F.R. § 240.3a 12-(5) (1976), which conditionally exempts from Regulation T, 12 C.F.R. § 220.1, and § 11(d) of the 1934 Act, the extension of credit by brokers in connection with investment contracts involving direct ownership of residential real property.

46. [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 80,130 (SEC Feb. 23, 1975). See also *Underwood, Neuhaus & Co.*, id. ¶ 80,187 (SEC Feb. 13, 1975).

47. [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 80,106 (SEC 1974).

48. Id. See 11 U.S.C. §§ 72, 107 (1970); 15 U.S.C. §§ 80a-1 to -52 (1970), as amended, (Supp. V, 1975).

interest is a security.⁴⁹ In *Hirsch v. du Pont*,⁵⁰ the court analyzed at length the elements of an investment contract and noted that because a general partner had the power to participate in the control of the affairs of the business, his interest was not an investment contract. Furthermore, a limited partnership interest is an investment contract, even if the holder later becomes a general partner.⁵¹ The *Hirsch* court also acknowledged that a general partnership interest may be an investment contract if the general partner does not have voting power.⁵²

II

RULE 10b-5

The Supreme Court's recent conservative approach to the construction of the federal securities laws is perhaps most evident in the two rule 10b-5⁵³ cases decided by the Court: *Blue Chip Stamps v. Manor Drug Stores*⁵⁴ and *Ernst & Ernst v. Hochfelder*.⁵⁵ Each should have a significant impact in limiting the growth of litigation under the rule, because of both the specific holdings and the theory expressed in the opinions.

Blue Chip Stamps and the Purchaser-Seller Requirement.—In *Blue Chip Stamps* the Supreme Court affirmed the rule, established twenty-three years earlier by the Second Circuit in *Birnbaum v. Newport Steel Corp.*,⁵⁶ that a plaintiff who has neither purchased nor sold securities

49. *McGreghar Land Co. v. Meguiar*, [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,273 (9th Cir. 1975); *Hirsch v. duPont*, 396 F. Supp. 1214 (S.D.N.Y. 1975); *New York Stock Exch., Inc. v. Sloan*, 391 F. Supp. 530 (S.D.N.Y. 1975).

50. 396 F. Supp. 1214 (S.D.N.Y. 1975).

51. *Id.* at 1228.

52. *Id.* at 1221.

53. 17 C.F.R. § 240.10b-5 (1976), promulgated under § 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) (1970). The rule provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

54. 421 U.S. 723 (1975).

55. 96 S. Ct. 1375 (1976).

56. 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952). For a discussion of the previous demise of the *Birnbaum* rule, see Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 Va. L. Rev. 268 (1968); Note, *Securities Regulation*, 1974/75 Ann. Survey Am. L. 129, 144-48.

may not maintain a private cause of action for money damages under rule 10b-5. *Blue Chip Stamps* arose out of a 1967 antitrust consent decree under which Blue Chip Stamp Company, which was in the business of providing trading stamps to retailers, would be reorganized, and a substantial number of shares of the reorganized company would be offered to retailers who were not previously shareholders of the company. The offering of the Blue Chip shares was registered under the Securities Act and slightly more than fifty percent of the offering was purchased. Plaintiff, a former user of the stamp service and an offeree of Blue Chip shares, brought suit two years after the offering on behalf of itself and all other offerees who had not purchased in the offering. Plaintiff alleged that the prospectus used in connection with the offering of Blue Chip shares was materially misleading in that it was overly pessimistic in presenting the company's status and prospects.⁵⁷ The district court dismissed the complaint on the basis of the *Birnbaum* rule,⁵⁸ and the Ninth Circuit reversed, holding that the facts warranted an exception to the rule.⁵⁹

The Supreme Court based its affirmance of the *Birnbaum* rule on four grounds: precedent, history, statutory analysis, and policy. As to precedent and history, the Court referred to the wealth of lower court decisions accepting *Birnbaum* and to the congressional declinations in 1957 and 1959 to amend section 10 (b) of the Exchange Act to make it applicable to "attempts" to purchase or sell.⁶⁰ These factors, the Court said, taken together "[argue] significantly in favor of the [adoption of the] *Birnbaum* rule by this Court."⁶¹ In its statutory analysis the Court noted that the principal express civil liability provisions of the Exchange Act and the Securities Act are, by their terms, available only to purchasers or sellers⁶² and concluded that "[i]t would indeed be anomalous

57. 421 U.S. at 726.

58. 339 F. Supp. 35 (C.D. Cal. 1971).

59. 492 F.2d 136 (9th Cir. 1973). The Ninth Circuit, stating that one of the essential reasons for the *Birnbaum* rule was the difficulty of ascertaining the amount of damages suffered by a nonpurchasing offeree, found that the difficulty did not exist under the Blue Chip consent decree. *Id.* at 141. Indeed, the decree specifically set out the total number of shares to be offered to stamp users who were previously not stockholders, and contained a formula to determine how many shares were to be offered to each based on the quantity of stamps issued to each user during a designated period. The offering price was also set by the consent decree. *Id.* at 139. Since the decree thus created a class of nonpurchasing offerees with no accompanying uncertainties as to how much or at what price they would have purchased, the court held that the *Birnbaum* rule did not apply. *Id.* at 142. Judge Hufstедler dissented, finding the lack of unascertainable damages not determinative of standing. *Id.* at 142-48. See text at note 66 *infra*.

60. 421 U.S. at 732-33. See Hearings Before Subcomm. of Senate Comm. on Banking & Currency, 86th Cong., 1st Sess. 367-68 (1959); S. 2545, 85th Cong., 1st Sess. (1957).

61. 421 U.S. at 733.

62. *Id.* at 736. Sections 11(a) and 12 of the Securities Act of 1933, 15 U.S.C. §§ 77k(a), 77l (1970), are available only to persons "acquiring" or "purchasing" the

to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action."⁶³

The Court conceded, however, that analysis of the congressional enactment did not offer conclusive guidance and that it was therefore proper to weigh "policy considerations"⁶⁴ in determining the propriety of the *Birnbaum* rule. The Court was particularly concerned that abandonment of the purchaser-seller requirement would result in a proliferation of "strike" suits and a concomitantly increased burden on corporate time and money, with the outcome of such suits determined almost entirely by oral testimony.⁶⁵ In addition, the Court rejected the position of the Court of Appeals that an exception to *Birnbaum* was warranted because the plaintiffs were the beneficiaries of an antitrust decree and thus a limited and identifiable class. The Court stated that if it were to agree with the Ninth Circuit in this regard, it "would leave the *Birnbaum* rule open to endless case-by-case erosion depending on whether a particular group of plaintiffs was thought . . . to be sufficiently more discrete than the world of potential purchasers at large to justify an exception."⁶⁶

While the Court's language does not appear to augur well for the viability of some of the previously created judicial exceptions to the *Birnbaum* doctrine,⁶⁷ their future will have to await further judicial action.⁶⁸ Nevertheless, it is clear that in certain circumstances a person

security. Sections 9 and 18 of the Exchange Act, id. §§ 78j(e), 78r(a), are available only to persons "who shall purchase or sell any security" or "who . . . shall have purchased or sold a security," respectively.

63. 421 U.S. at 736.

64. Id. at 737.

65. Id. at 742.

66. Id. at 755.

67. See Jacobs, *Standing to Sue Under 10b-5 After Blue Chip Stamps*, 3 Sec. Reg. L.J. 387 (1976); Comment, 44 Ford. L. Rev. 452 (1975).

68. The conservative purchaser-seller holding of *Blue Chip* will undoubtedly have ramifications beyond that specific standing context, and these ramifications are beginning to emerge. For example, *Bio-Medical Sciences, Inc. v. Weinstein*, 407 F. Supp. 970 (S.D.N.Y. 1976), involved an action by a corporation against its former president's estate alleging that he had fraudulently induced institutional lenders to purchase convertible debt securities from the corporation. When the misrepresentations were discovered, the corporation was forced to its detriment to renegotiate the terms of the debt. The court, taking its cue from *Blue Chip*, rejected the corporation's 10b-5 argument, holding that the "in connection with" requirement of the rule mandated that the loss result from the sale itself and not merely have some relationship to the sale. Id. at 973. Although the holding of *Blue Chip* was irrelevant to the *Bio-Medical* issues, it was viewed as indicating that "the 'judicial oak' should be trimmed back rather than force-fed." Id. See also *Myers v. American Leisure Time Enterprises*, [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,286 (S.D.N.Y. 1975) (*Blue Chip* would be frustrated by permitting a target company shareholder who had neither purchased nor sold securities to maintain a damage action under § 13(d) of the Williams Act, 15 U.S.C. § 78m(d) (1970)).

who is neither a purchaser nor a seller in the conventional sense will be able to maintain a private damage action under rule 10b-5. The lower courts, with apparent approval of the *Blue Chip* Court,⁶⁹ have held that since the Exchange Act defines "purchase" to include a contract to purchase, and "sale" to include a contract to sell,⁷⁰ parties to such contracts have the status of purchasers or sellers for purposes of the purchaser-seller requirement.

In *Camp v. Genesco*,⁷¹ the District Court for the Southern District of New York found that the holder of convertible preferred stock who alleged that defendant's misrepresentations caused him not to convert had a claim under rule 10b-5, since the conversion right was the equivalent of a contract. Similarly, *Wulc v. Gulf & Western Industries, Inc.*⁷² held that the holder of unexercised options to purchase shares in an issuer which was merged into another company had standing to maintain a 10b-5 action for misrepresentation in connection with the merger, since the option was a contract to sell securities. In *Davis v. Davis*,⁷³ the Fifth Circuit held that a plaintiff who was party to a contract to sell stock and who alleged a fraudulent scheme to cut off his financial resources to force him to sell at a fraction of the contract price had standing under rule 10b-5. In a different factual context, *Murphy v. Hillwood Villa Associates*⁷⁴ held that a party to a contract had standing as a seller under rule 10b-5 where the defendant allegedly fraudulently induced plaintiff to make payment under the contract to the wrong party. Finally, *Desser v. Ashton*⁷⁵ held that an oral contract to purchase or sell securities, while perhaps not enforceable under a statute of frauds, was nevertheless sufficient to confer on the plaintiff purchaser or seller status in satisfaction of the *Blue Chip* requirement.

While it is clear under *Blue Chip* that mere retention of an investment in reliance on misrepresentation is not actionable under rule 10b-5,⁷⁶ *Fischer v. New York Stock Exchange, Inc.*⁷⁷ held that an agreement to extend a loan which would otherwise come due constituted a new purchase for rule 10b-5 purposes, and *New York Stock Exchange, Inc. v. Sloan*⁷⁸ held that the failure to demand repayment of a loan

69. See 421 U.S. at 750-51.

70. See *id.* at 750 n.13. The definitions are contained in 15 U.S.C. §§ 78(c)(13)-(14) (1970).

71. [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,473 (S.D.N.Y. Mar. 17, 1976).

72. 400 F. Supp. 99 (E.D. Pa. 1975).

73. 526 F.2d 1286, 1289 (5th Cir. 1976).

74. 411 F. Supp. 287, 291 (S.D.N.Y. 1976).

75. 408 F. Supp. 1174 (S.D.N.Y. 1976).

76. See 421 U.S. at 737-38.

77. 408 F. Supp. 745, 755 (S.D.N.Y. 1976).

78. [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,480 (S.D.N.Y. Mar. 25, 1976).

made under an agreement providing for automatic renewal absent demand also constituted a new purchase.

The *Birnbaum* rule has been held to apply to situations in which an issuer is the purchaser or seller of its own securities. In *Wright v. Heizer Corp.*⁷⁹ the court held that shareholders of a corporate seller of securities could not maintain a private 10b-5 action individually, but could maintain the action derivatively on behalf of the corporation, and *Harriman v. E.I. DuPont de Nemours & Co.*⁸⁰ held that shareholders of a corporation party to an unconsummated merger could maintain a derivative action. In an interesting contrast, the *Wright* court concluded that, while *Blue Chip* involved a claim for damages, the purchaser-seller requirement should also be read into private actions for injunctive relief.⁸¹ *Harriman* stated that the line of cases not requiring purchaser or seller status in injunctive actions "arguably retain[s] post-*Blue Chip* vitality."⁸²

Hochfelder and the Scienter Requirement.—In *Ernst & Ernst v. Hochfelder*,⁸³ the Supreme Court, reversing the Seventh Circuit, held that a private cause of action for damages may not be brought under section 10 (b) and rule 10b-5 in the absence of an allegation of "scienter," which the Court stated "refers to a mental state embracing intent to deceive, manipulate or defraud."⁸⁴

As in *Blue Chip*, the Court based its holding on several grounds: the language of the statute, legislative history, the circumstances surrounding the promulgation of the rule, and an analysis of the express civil liability provisions in the Securities Act and the Exchange Act.

Justice Powell, writing for the majority, found that the use of the words "manipulative or deceptive" in conjunction with "device or contrivance" in the statute "strongly suggest[s] that section 10 (b) was intended to proscribe knowing or intentional misconduct,"⁸⁵ since such language "clearly connotes intentional misconduct"⁸⁶ This interpretation of the statutory language was bolstered by the Court's analysis of the legislative history, which was viewed as indicating that the section was meant to control "manipulative [or cunning] devices."⁸⁷ The rule itself was a "hastily drafted response to a situation clearly involving

79. 411 F. Supp. 23, 31 (N.D. Ill. 1975).

80. 411 F. Supp. 133, 157 (D. Del. 1975).

81. 411 F. Supp. at 23-34.

82. 411 F. Supp. 133, 157. See e.g., *Mutual Shares Corp. v. Genesco, Inc.* 384 F.2d 540 (3d Cir. 1973); *Kahan v. Rosenstiel*, 424 F.2d 161 (3d Cir.), cert. denied, 398 U.S. 950 (1970); *Britt v. Cyril Bath Co.*, 417 F.2d 433 (6th Cir. 1969).

83. 96 S. Ct. 1375 (1976), rev'g 503 F.2d 1100 (7th Cir. 1974).

84. Id. at 1381.

85. Id. at 1383.

86. Id. at 1384.

87. Id. at 1386.

intentional misconduct.”⁸⁸ The intent of Congress and the SEC, therefore, was not to adopt a broad rule but merely to limit market frauds.⁸⁹ The Court stated that “[i]n each instance that Congress created express civil liability in favor of purchasers or sellers of securities it clearly specified whether recovery was to be premised on knowing or intentional conduct, negligence, or entirely innocent mistake.”⁹⁰ Analyzing sections 11, 12(2) and 15 of the 1933 Act, the Court noted that those sections allow recovery for negligent conduct subject to “significant procedural restrictions not applicable under 10(b).”⁹¹ The Court explained:

We think these procedural limitations indicate that the judicially created private damage remedy under § 10(b)—which has no comparable restrictions—cannot be extended, consistently with the intent of Congress, to actions premised on negligent wrongdoing. Such extension would allow causes of action covered by § 11, § 12(2) and § 15 to be brought instead under § 10(b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions.⁹²

While the Court specifically disclaimed a position on whether recklessness is a form of intentional misconduct,⁹³ it also left the impression that something less than actual intent may provide the basis for a section 10(b) action. Thus, the Court stated that “the relevant portions of that [legislative] history support our conclusion that § 10(b) was addressed to practices that involve *some* element of scienter and cannot be read to impose liability for negligent conduct *alone*.”⁹⁴ At another point, the opinion states that “there is no indication . . . that § 10(b) was intended to proscribe conduct *not involving scienter*.”⁹⁵ The Court also ratified a description of the section “as a ‘catch-all’ to enable the Commission to ‘deal with new manipulative [or cunning] devices.’ It is difficult to believe that any lawyer, legislative draftsman or legislator would use these words if the intent was to create liability for *merely negligent* acts or omissions.”⁹⁶ Finally, the Court stated that “[t]here is no indication that Congress intended anyone to be made liable for such practices [wash sales, matched orders and other illicit trading practices]

88. Id. at 1390 n.32.

89. Id. at 1387, 1390.

90. Id. at 1388.

91. Id.

92. Id. at 1389.

93. Id. at 1381 n.12.

94. Id. at 1385 (emphasis added).

95. Id. at 1387 (emphasis added).

96. Id. at 1385 (emphasis added).

unless he acted *other than in good faith*. The catch-all provision of § 10(b) should be interpreted no more broadly."⁹⁷

The opinion expressly leaves open several other questions:

o The Court does not consider whether civil liability for aiding and abetting is appropriate under section 10(b) and rule 10b-5 or the elements necessary to establish such a cause of action.⁹⁸

o The Court does not consider whether scienter is a necessary element in an action for injunctive relief under section 10(b) and rule 10b-5.⁹⁹

o The Court does not consider whether a cause of action may be maintained under section 10(b) on the basis of a violation of section 18 of the 1934 Act which provides for a private cause of action by any person against any other person who makes a materially misleading statement in 1934 Act commission filings. The Court notes that the legislative history surrounding section 18 "suggests something more than negligence on the part of the defendant is required for recovery."¹⁰⁰

Materiality and Reliance.—*Titan Group, Inc. v. Faggen*,¹⁰¹ contains a brief but lucid explanation by Judge Waterman of the relationship between materiality and reliance as elements of a rule 10b-5 damage cause of action. The court noted that the elements of materiality and reliance restrict the applicability of the rule to those situations where there is causation in fact between the alleged wrong and the injury,

97. Id. at 1387 (emphasis added).

98. Id. at 1380 n.7. See e.g., *Woodward v. Metro Bank*, 522 F.2d 84 (5th Cir. 1975); *Rochez Bros. v. Rhoades*, 527 F.2d 880 (3d Cir. 1975); *Thomas v. Duralite Co.*, 524 F.2d 577 (3d Cir. 1975); *Aid Auto Stores v. Cannon*, 525 F.2d 468 (2d Cir. 1975); *H.L. Federman & Co. v. Greenberg*, 405 F. Supp. 1332 (S.D.N.Y. 1975); *SEC v. Sorg Printing Co.*, [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,034 (S.D.N.Y. 1975).

99. 96 S. Ct. at 1381 n.12. In his dissent, Justice Blackmun (joined by Justice Brennan) stated he could see no distinction between an injunctive action brought by the SEC and a private damage action, "for surely the question whether negligent conduct violates the Rule should not depend on the plaintiff's identity." Id. at 1392.

In a memorandum to all staff attorneys (BNA Sec. Reg. L. Rep., No. 354, at F-1 (May 26, 1976)) the General Counsel of the SEC warns the staff that it is to be anticipated that the *Hochfelder* issue will be raised by defense counsel attempting to resist SEC injunctive actions and sets forth "initial observations" relevant to resisting such efforts. Included among such suggestions are that the staff avoid allegations of willful or reckless conduct and instead allege only that the defendants "violated" the statute so that there will be flexibility in proving the case while avoiding the risk of being required to meet a more difficult standard, and that, particularly in cases where "proof of knowledge is slim," the staff avoid "aiding and abetting" allegations and instead allege that the defendants violated the statute "directly or indirectly." The memorandum also suggests that whenever possible the staff allege violations of provisions in addition to rule 10b-5, "particularly Section 17(a) of the Securities Act, which may not be subject to the scienter requirements of Section 10(b)."

100. 96 S. Ct. at 1389-91 & n.31.

101. 513 F.2d 234, 238-39 (2d Cir.), cert. denied, 423 U.S. 840 (1975).

since causation is a necessary element in a private damage action. In cases where there is affirmative misstatement, plaintiff must prove both materiality and reliance. In nondisclosure cases, however, direct proof of reliance is not possible, and proof of materiality (i.e., whether a reasonable man would have attached importance to the omitted fact in determining his course of conduct) becomes decisive in determining whether causation exists.¹⁰²

In the Ninth Circuit, *Blackie v. Barrack*¹⁰³ held that the proof of subjective reliance on misrepresentations was unnecessary to establish a 10b-5 claim alleging a deception which inflated the price of a publicly traded security. The court found that in the impersonal stock exchange context, proof of materiality of the misrepresentation established the reliance of at least some market traders which led to the inflation of the price of the security. When the plaintiff purchased at the inflated price the element of causation between the misrepresentation and the injury was established. Of course, the defendant was free to disprove the element of causation by showing either a lack of materiality (or that despite materiality an insufficient number of traders relied to affect the price), or that the individual plaintiff knew of the falsity of the statement or would have purchased even had he known of the falsity of the statement.¹⁰⁴

In *SEC v. Geon Industries, Inc.*,¹⁰⁵ Judge Friendly dealt with the question of the materiality of selective disclosure of preliminary negotiations relating to a potential merger of Geon into a substantially larger company.¹⁰⁶ In holding such information material, the court stressed that the concept of materiality in the context of disclosure of inside information to a favored few "has a different aspect than when the issue [of materiality] is, for example, an inaccuracy in a publicly disseminated press release. . . ."¹⁰⁷ In addition, the court suggested that such selectively disclosed information may be material simply because of its source. In response to defendant's assertions that the information with respect to early stage discussions is immaterial per se, the court held that materiality depends both on the likelihood that the potential event would occur, and on the magnitude of such event:

102. Id. at 239. For the Supreme Court's formulation of the materiality standard in the proxy statement context, see note 129 infra.

103. 524 F.2d 891, 905-08 (9th Cir. 1975), cert. denied, 45 U.S.L.W. 3220 (U.S. Oct. 4, 1976).

104. Id. at 904-06.

105. 531 F.2d 39 (2d Cir. 1976).

106. Id. at 47-49.

107. Id. at 48.

Since a merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death, we think that inside information, as regards a merger of this sort, can become material at an earlier stage than would be the case as regards lesser transactions—and this even though the mortality rate of mergers in such formative stages is doubtless high.¹⁰⁸

The court, however, expressly noted that its holding did not mean that public disclosure of the preliminary stage negotiations was either necessary or appropriate absent the selective disclosure. Premature dissemination of such information might itself be misleading because of the possibility of creating unfounded market activity. The court concluded that during such preliminary stages, "silence is indeed golden."¹⁰⁹

At a later stage of the merger discussions involved in *Geon*, the corporation's president informed certain persons that the directors would meet shortly to "rubber stamp" the transaction. The court held that a board meeting to act upon a proposed merger is clearly material information. It is a signal for arbitrageurs to narrow the price gap, and the call for such a meeting should either be kept confidential (with a ban on insider trading and tipping) or publicly disclosed.¹¹⁰

Duty to Investigate and Access to Information.—*Metro-Goldwyn-Mayer, Inc. v. Ross*,¹¹¹ decided by the Second Circuit, pointed out the danger in a corporate acquisition transaction of attempting to fulfill disclosure requirements simply by allowing the purchaser access to information. The court, in a situation where the relevant facts were ascertainable from the books and records of the acquired corporation but were apparently difficult to sift out, held that the disclosure requirements of rule 10b-5 were not satisfied simply by giving the purchaser access and permitting him to piece the facts together if he could.

108. Id. at 47-48.

109. Id. at 48. *Geon* also held that an officer who gives false information on the status of a proposed merger to a stock exchange official who is seeking such information to determine whether to halt trading in the security violates rule 10b-5. Id. at 49-50. The court acknowledged that the status of the transaction in *Geon* was not sufficiently crystallized to call for a press release and that the officer could have legally responded with "no comment" to inquiries from stockholders or brokers. The officer, however, could not misstate the status of the proposed transaction to the exchange or withhold information necessary to a determination on a trading halt. Id. at 50.

110. Id. at 47.

Another disclosure case, *Goodman v. Poland*, 395 F. Supp. 660 (D. Md. 1975), held that the duty to disclose under rule 10b-5 terminates at the time all parties are bound, and that therefore, there is no duty to disclose events occurring subsequently. The court reasoned that the purpose of the rule is to prevent insiders and tippees from taking undue advantage of others, and not to provide an escape hatch for avoiding transactions. Id. at 689-91.

111. 509 F.2d 930 (2d Cir. 1975).

Rather, the rule imposes an affirmative duty to disclose material facts.¹¹² Contrasted with the *Metro-Goldwyn-Mayer* opinion is the subsequent decision of the Southern District of New York in *Caan v. Kane-Miller Corp.*¹¹³ In *Caan*, the court found that a reasonable inspection of the acquired corporation's books would have revealed the allegedly material facts, and it distinguished *Metro-Goldwyn-Mayer* on the basis of the extent of the investigation there required. In the course of "complicated merger negotiations, there is no affirmative duty to direct a sophisticated purchaser . . . to all routine information which it should be able to uncover in the course of a reasonable investigation."¹¹⁴ Rule 10b-5, the court stated, cannot be used as an "insurance policy" for persons who choose "to disregard facts which would have been uncovered by any reasonable person in their position."¹¹⁵

Similarly, *Arlinghaus v. Ritenour*¹¹⁶ held that a shareholder in a closely held corporation who claimed that her counsel had purchased her stock without telling her of negotiations to resell the stock at a higher price, had not satisfied the diligence requirement implicit in rule 10b-5. The court's holding turned on her failure to consult her brother-in-law, who was a director of the corporation and in a position to advise her of the value of her stock. In the Tenth Circuit, *Holdsworth v. Strong*¹¹⁷ noted that ordinarily a due diligence defense implicit in rule 10b-5 cases will not bar a plaintiff's recovery if there has been an intentional fraud by the defendant. The plaintiff in *Holdsworth*, who was an officer and director of the issuer (a small corporation without a readily ascertainable market value) was not barred even though he made no investigation at all.¹¹⁸ *Aixala v. W.E. Hutton & Co.*¹¹⁹ held that a subordinated lender to a brokerage firm was not barred from a 10b-5 recovery by reason of his failure to request to examine another subordinated loan agreement, the provisions of which the court found would have been material to the plaintiff's decision to make the loan.

While the foregoing cases all involved "face-to-face" acquisition transactions, similar due diligence principles have been applied in other situations. For example, the court in *Pollack v. Eastman Dillon*¹²⁰ held that a plaintiff who made purchases based upon a broker's favorable

112. *Id.* at 933.

113. [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,446 (S.D.N.Y. Feb. 5, 1976).

114. *Id.* at 99,242.

115. *Id.*

116. [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,288 (S.D.N.Y. 1975).

117. 372 BNA Sec. Reg. & L. Rep. A-3 (10th Cir. Sept. 29, 1976) (en banc).

118. *Id.*

119. [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,981 (S.D.N.Y. 1975).

120. [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,987 (S.D.N.Y. 1975).

recommendation could not recover against the broker for failure to reveal subsequent adverse information since such information was contained in the issuer's published financial reports.

Conclusion.—While 10b-5 continues to be the source of the bulk of securities litigation, the limiting effects of both *Blue Chip* and *Hochfelder* are just beginning to emerge. Clearly, the Supreme Court's generally conservative view of at least the private damage remedies available under the Exchange Act will permeate consideration of related issues by the lower courts.¹²¹ The far-reaching effects of the decisions, of course, remain a topic to be covered in the future.

III

TAKEOVERS

Resort to the federal courts continued to be a favorite tactic of a management attempting to resist an unwanted takeover attempt. The pattern of the decisions in large part continues to reflect congressional intent that the Williams Act,¹²² which, along with various state laws,¹²³

121. See, e.g., *Bio-Medical Sciences, Inc. v. Weinstein*, 407 F. Supp. 970 (S.D.N.Y. 1976), discussed in note 68 *supra*.

122. Securities Exchange Act of 1934, §§ 13d-c, 14d-f, 15 U.S.C. §§ 78m(d)-(c), n(d)-(f) (1970).

123. While the Williams Act has been the primary regulator of takeover battles, state tender offer statutes and proceedings promise to play an increasingly important role. When the Williams Act was passed in 1968, Virginia was the only state with takeover legislation. Va. Code Ann. §§ 13.1-528 to 13.1-541 (Replacement Vol. 1973). Twenty-two other states currently have takeover statutes.

The state takeover laws are as follows: Alaska Stat. §§ 45.57.010-45.57.120 (1 Blue Sky L. Rep. ¶ 6,209 (June 8, 1976)); Colo. Rev. Stat. Ann. § 11-51.5-101 (Supp. 1975); P.A. 76-362, [1976] Conn. Laws 729; Del. Code Ann. tit. 8 § 203 (1 Blue Sky L. Rep. ¶ 11,131 (April 24, 1976)); Hawaii Rev. Stat. ch. 417E (Supp. 1975); Idaho Code §§ 30-1501 to 30-1513 (Supp. 1975); Ind. Code §§ 23-2-3-1 to 23-2-3-12 (Burns Supp. 1976); Kan. Stat. Ann. §§ 17-1276 to 17-1285 (1A Blue Sky L. Rep. ¶¶ 19,351-60 (Mar. 30, 1976)); Ky. Rev. Stat. Ann. §§ 292.560-292.630 (Baldwin Rev. Stat. Serv. 1976); La. Rev. Stat. Ann. §§ 51:1500-51:1512 (1A Blue Sky L. Rep. ¶¶ 21,151-63 (June 28, 1976)); Md. Ann. Code art. 11, §§ 901-08 (1A Blue Sky L. Rep. ¶¶ 23,421-27 (May 17, 1976)); ch. 121 [1976] Mass. Laws 125; P.A. 179 [1976] Mich. Laws 409; Minn. Stat. Ann. ch. 80B (Supp. 1976); Nev. Rev. Stat. §§ 78.376-78.378 (1973); N.Y. Bus. Corp. Law ch. 4, art. 16, §§ 1600-1613 (2 Blue Sky L. Rep. ¶¶ 35,351-64 (July 27, 1976)); Ohio Rev. Code Ann. § 1707.041 (Page Supp. 1975); Act 19 [1976] Pa. Laws 33; S.D. Compiled Laws Ann. ch. 47-32 (Supp. 1976); Tenn. Code Ann. §§ 48-2101 to 48-2115 (3 Blue Sky L. Rep. ¶¶ 45,191-205 (Mar. 17, 1976)); ch. 30 [1976] Utah Laws 121; Wis. Stat. Ann. ch. 552 (Special Pamphlet 1975).

For a general discussion, see Vaughan, *State Tender Offer Regulation*, 9 Rev. Sec. Reg. 969 (1976). Virtually all of the statutes require the filing of offering materials a specified number of days before the offer is made. Many states also provide for administrative hearings at the request of the target or upon motion of the state

regulates takeover contests, be construed not to tip the balance toward an entrenched management but to compel full and fair disclosure to investors, while at the same time giving management and the offeror an equal opportunity to fairly present their views.¹²⁴

Disclosure Requirements.—Recent cases have rejected a mechanical approach to the determination of materiality of a particular disclosure in favor of the more realistic approach of whether in the overall context investors were given, or had readily available, sufficient information to make an informed investment decision. Thus, *Spielman v. General Host Corp.*¹²⁵ defined materiality in the exchange offer-tender offer context as follows:

[T]he fact that there is a contest for control means that a failure to present information may be rendered harmless by disclosure from others, such as the target company, the competing tenderor or outside sources. A defendant may not be faulted for failure to repeat material information which has been publicly proclaimed in various ways on other occasions. . . .

The issue presented by this case, therefore, is . . . whether . . . security holders were unable to make an informed investment decision because of alleged deficiencies in the [offering material], defects which . . . were never cured by information contained in other communications to [the target's] shareholders.¹²⁶

The court in *Commonwealth Oil Refining Co. v. Tesoro Petroleum Corp.*,¹²⁷ while recognizing that disclosure deficiencies can be cured by publicly available information or disclosure by third parties, stated that if the offeror limits the target's ability to respond by stipulating a short offer period (there, eleven days), the offeror will be held to a higher standard of disclosure.¹²⁸

Since the total mix of information should be considered, the appropriate question for a determination of materiality in the tender offer context is whether a shareholder would have considered the omitted fact or correct information important in reaching a decision whether

authority. Many also provide substantive rights which exceed those under the Williams Act. For a discussion of the constitutionality of such legislation, see Note, Commerce Clause Limitations upon State Regulation of Tender Offers, 47 S. Cal. L. Rev. 1133 (1974).

124. S. Rep. No. 550, 90th Cong., 1st Sess. 3 (1967); H.R. Rep. No. 1711, 90th Cong., 2d Sess. 4 (1968); *GAF Corp. v. Milstein*, 453 F.2d 709, 716-17 & n.16 (2d Cir. 1971), cert. denied, 406 U.S. 910 (1972).

125. 402 F. Supp. 190 (S.D.N.Y. 1975).

126. *Id.* at 194-95.

127. 394 F. Supp. 267 (S.D.N.Y. 1975).

128. *Id.* at 274-75 n.1.

to tender.¹²⁹ Thus, in *Copperweld Corp. v. Imetal*,¹³⁰ which involved a cash tender offer by a French company for all of the outstanding stock and convertible debentures of an American company, the court held that the understatement of the offeror's earnings by approximately \$100 million, resulting from differences between French and American accounting principles, was not material in that particular factual context.¹³¹ The court reached its holding on the basis of its findings that the understatement did not alter the "general health" of the offeror or impair its ability to pay for the shares tendered and that the offer price substantially exceeded the historical market price of the target's shares. Under these circumstances, the court did not believe a reasonable investor would find the earnings understatement important in deciding whether to tender.¹³²

Specific Disclosure Problems.—The plans, purposes, and proposals disclosures required under the Williams Act¹³³ produced several interesting holdings during 1975. In *Missouri Portland Cement Co. v. H.K. Porter Co.*,¹³⁴ the offer to purchase stated that the offeror had no intention of seeking representation on the target's board of directors, but that its offer, which if successful would have given it just under fifty percent of the target's stock, was to increase its investment in the target company, which might give the offeror "effective working control of [the target]."¹³⁵ The court found, without casting any doubt on the representation as to directors, that an offer designed to increase the offeror's holdings to almost fifty percent would, if successful, achieve control and that the statements on "investment" and "effective working

129. See, e.g., *Spielman v. General Host Corp.*, 402 F. Supp. 190, 194 (S.D.N.Y. 1975); *Commonwealth Oil Ref. Co. v. Tesoro Petroleum Corp.*, 394 F. Supp. 267, 274-75 (S.D.N.Y. 1975); *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937, 948 (2d Cir. 1969). For the question, presented in the context of an acquisition proxy statement, of whether the test is "would," "might," or would have a "significant propensity" to affect shareholder decision, see *TSC Indus., Inc. v. Northway, Inc.*, 96 S. Ct. 2126 (1976); *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 384-86 (1970); Brief for SEC as Amicus Curiae, *Northway*, supra. In *Northway*, the Court reversed the Seventh Circuit's formulation that material facts were those which a reasonable investor "might" consider important, and defined a fact in the proxy context to be material when "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote," but it is not necessary to show that correct disclosure would have caused the reasonable shareholder to actually change his vote. 96 S. Ct. at 2133.

130. 403 F. Supp. 579 (W.D. Pa. 1975).

131. Id. at 602.

132. Id.

133. Section 13(d)(1)(C), 15 U.S.C. § 78m(d)(1)(C) (1970); SEC Reg. 14d-1C, 17 C.F.R. § 240.14d-1(c)(4) (1976); Schedule 13D, Item 4, 17 C.F.R. § 240.13d-101, Item 4 (1976).

134. No. 75-1027C(A) (E.D. Mo., Nov. 26, 1975).

135. Id. at 11.

control" did not meet the disclosure requirements of the Williams Act.¹³⁶ *Jewelcor, Inc. v. Pearlman*¹³⁷ held that if the acquiring company has purchased shares for investment and to strengthen its position in anticipation of merger discussions, schedule 13D need only state that the purpose of the purchase is "investment" as long as it also discloses that a possible merger was or will be considered.¹³⁸ If the purpose of the purchases is to frustrate a takeover by a third party, that fact must also be disclosed.¹³⁹ *Alaska Interstate Co. v. McMillian* further stipulates that legal or factual impediments to the accomplishment of the offeror's purpose, such as expected opposition from the target or a third party, are required items of disclosure.¹⁴⁰

The question whether the offeror is required to disclose the details of a plan to merge the target after consummation of a tender offer received interesting treatment in two cases. In *Otis Elevator Co. v. United Technologies Corp.*¹⁴¹ the offeror, prior to its offer, had attempted to negotiate a "friendly" merger with the target. In connection with the attempt, the offeror prepared a study showing the effect on it of a cash tender offer followed by a second-step merger using a specific exchange ratio. The study was presented to the offeror's board when it approved the cash tender offer, but the board did not act on the study or approve the second-step merger. Neither the study nor the extensive consideration given to it by officers of the offeror was disclosed in the offer to purchase, which stated only that preliminary merger discussions were conducted with the target, that the discussions had been terminated, and that the offeror "ha[d] not formulated any plan or proposal to merge" the target.¹⁴² In holding that the details of the merger plan should have been disclosed and rejecting the offeror's argument that the plan was "inchoate" and not material, the court stated that "a plan or proposal will not be considered inchoate but rather . . . material if there is strong evidence of its adoption by high corporate officers over a period of time."¹⁴³

In *Alaska Interstate Co. v. McMillian*,¹⁴⁴ on the other hand, the

136. Id. at 12.

137. 397 F. Supp. 221 (S.D.N.Y. 1975).

138. Id. at 237-39.

139. See id. at 239.

140. 402 F. Supp. 532, 550-53 (D. Del. 1975).

141. 405 F. Supp. 960 (S.D.N.Y. 1975).

142. Id. at 963. If instead of not acting on the merger plan, the board had specifically rejected it, there would presumably have been sufficient evidence to show that the offeror was not committed to the plan and no disclosure would have been required. See *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937, 941 (2d Cir. 1969).

143. 405 F. Supp. at 971.

144. 402 F. Supp. 532 (D. Del. 1975).

court found no evidence that a decision had been made by the board or top management of the offeror on the terms of a merger between the target and the offeror and, accordingly, refused to require disclosure of "hypothetical" terms furnished to a bank which financed the offer. The court noted that in every tender offer involving a possible combination of the offeror and the target, the target will conduct analysis to determine the feasibility of its plan. If no specific terms have been decided upon, reference to possible terms, even labeled as such, "will not ordinarily provide a basis for informed stockholder judgment and will hold some potential for miscommunication."¹⁴⁵ In the absence of a decision by the offeror on specifics, the *Alaska Interstate* court accepted a general statement to the effect that a merger was desired by the offeror and that the terms thereof would depend upon various factors and could not then be predicted.¹⁴⁶

In view of the Second Circuit's decisions in *Green v. Santa Fe Industries, Inc.* and *Marshel v. AFW Fabrics Corp.*,¹⁴⁷ it may be that any disclosure made with respect to possible merger plans to eliminate the remaining minority interest in the target should be accompanied by appropriate language drawing attention to such decisions and the effect they may have on consummation of such plans.

The question of whether the offeror is required to include its financial statements in an offer to purchase has also received judicial attention since the beginning of 1975. *Copperweld Corp. v. Imetal* and *Alaska Interstate Co. v. McMillian* both indicated that even though a shareholder might find them important in reaching a decision on whether or not to tender, the offeror's financial statements need not be included in the offer to purchase if they are otherwise publicly available.¹⁴⁸ In *Copperweld*, the court found such availability by reason of the inclusion of financial statements in the offeror's schedule 13D, which was on file at the New York Stock Exchange and the SEC.¹⁴⁹ The *Alaska Interstate* court found such availability because the offeror was a public company regularly filing the requisite periodic and annual reports.¹⁵⁰ The *Copperweld* court indicated its belief that the offeror's

145. Id. at 543. See *Susquehanna Corp. v. Pan Am. Sulphur Co.*, 423 F.2d 1075, 1085-86 (5th Cir. 1970).

146. 402 F. Supp. at 540-43.

147. See notes 200-20 infra and accompanying text.

148. 403 F. Supp. at 597; 402 F. Supp. at 548. *Alaska Interstate* implies that if all tendered shares need not be accepted and a second-step merger in exchange for securities of the offeror is contemplated, with the exchange ratio having already been decided, financial statements of the offeror would be required to be included since the offeror is in reality telling the target's shareholders to tender now for cash or receive securities in the second-step merger. Id.

149. 403 F. Supp. at 598.

150. 402 F. Supp. at 546-47.

financial statements are not material and thus not required to be made public if the offer is to purchase *all* of the outstanding stock of the target; but in cases similar to *Corenco Corp. v. Schiavone & Sons*,¹⁵¹ where the offer is for only a part of the target's shares with a second-step merger contemplated, or where the target may be the ultimate source of funds for the offer, disclosure should be required if the information is not otherwise publicly available.¹⁵²

Alaska Interstate found no duty on the part of the offeror to disclose its own judgment with respect to liquidation values of the target's assets absent receipt of liquidating value appraisals from the target. If such appraisals have been furnished by the target, the offeror can disclose them and state that it has not relied thereon, giving the reasons for such nonreliance.¹⁵³ *Alaska Interstate* also held that the offeror is not required to disclose forecasts and estimates supplied by the target if they are not designed for public dissemination and do not show a significant reversal of trend from that reflected in publicly available information.¹⁵⁴

Several other interesting disclosure holdings in the takeover context have appeared since the beginning of 1975. *Commonwealth Oil Refining Co. v. Tesoro Petroleum Corp.*¹⁵⁵ held that the disclosure of potential material losses resulting from a change in control following a tender must include the dollar amounts of such losses to the extent they are determinable by the offeror. The fact that a tender offer for less than all of the shares of the target may result in such losses, through the loss of a license or other right, however, is not a per se violation of the Williams Act.¹⁵⁶

In the area of financing, one district court held that if the acquiring company has made substantial working capital borrowings, even though not earmarked for the tender offer, the borrowings should be disclosed as related to the acquisition of the shares of the target.¹⁵⁷ The purpose of the disclosure requirement with respect to the source of funds for

151. 362 F. Supp. 939, 948-49 (S.D.N.Y.), aff'd in part, 488 F.2d 207 (2d Cir. 1973).

152. 403 F. Supp. at 598-600. See *Missouri Portland Cement Co. v. Cargill, Inc.*, 375 F. Supp. 249 (S.D.N.Y.), aff'd in part, 498 F.2d 851 (2d Cir.), cert. denied, 319 U.S. 844 (1974), where the court held two years of information, in summary form, as to sales, net income, assets, net current assets and net worth to be sufficient.

153. 402 F. Supp. at 572.

154. *Id.* at 568.

155. 394 F. Supp. 267, 277-78 (S.D.N.Y. 1975).

156. See *id.* See also *Ronson Corp. v. Liquifin Aktiengesellschaft*, 483 F.2d 816 (3d Cir. 1973); *Texasgulf, Inc. v. Canada Dev. Corp.*, 366 F. Supp. 374 (S.D. Tex. 1973). *Commonwealth Oil* did not consider the question under state corporation or common law.

157. *Jewelcor, Inc. v. Pearlman*, 397 F. Supp. 221 (S.D.N.Y. 1975). See note 137 *supra* and accompanying text. For an excellent discussion of interesting questions arising under the margin rules in connection with a tender offer situation, see *Alaska Interstate Co. v. McMillian*, 402 F. Supp. at 558-65.

the offer, however, is to provide shareholders with the ability to determine whether the offeror can pay the purchase price. Accordingly, it is not necessary, in a situation where the offeror is to pledge the stock of the target as security for the tender offer loan, to disclose that the inability to refinance the loan could result in a change in control of the target.¹⁵⁸ An offeror who has good faith rational support for such a statement may state in its offer that it anticipates that cash flow will be sufficient to service a loan and does not have to disclose the cash flow projection providing the basis for such a statement.¹⁵⁹ *Emhart v. USM Corp.*¹⁶⁰ held the statements of a target company characterizing a tender offer as "quite inadequate" and as an attempt to obtain control at "bargain basement" prices to be misleading. The court found the statements failed to set forth that the target's stock had not recently traded above the offer price and that the target had negotiated with the offeror for an acquisition of the target at less than ten percent above the offer price within the preceding six months.

Tactics and Procedural Matters.—The courts generally have not been sympathetic to assertions that procedural craftiness violates the Williams Act. In *Commonwealth Oil*, the court held that a "secret" and then "sudden" offer was not a violation, even though it was open for only a short period and was obviously disadvantageous to the target.¹⁶¹ "Cornering" all three of the leading proxy soliciting firms and thereby further limiting the target's ability to respond was similarly not a violation.¹⁶² Finally, the *Commonwealth Oil* court held that notifying the New York Stock Exchange of the impending offer, which resulted in a trading suspension which froze the price, was not prohibited by the Williams Act.¹⁶³

*Mesa Petroleum Co. v. Aztec Oil & Gas Co.*¹⁶⁴ is the first case under section 14(e) of the Williams Act ordering a target in a hostile tender offer to furnish the offeror with a shareholder list. While *Mesa Petroleum* held that the refusal by the target to supply the offeror with such

158. *Alaska Interstate Co. v. McMillan*, 402 F. Supp. at 578-79.

159. *Id.* at 546.

160. CCH Fed. Sec. L. Rep. ¶ 95,334 (D. Mass. 1975).

161. 394 F. Supp. at 274-75 & n.1.

162. *Id.* at 280.

163. *Id.* In addition to freezing the price, a trading halt has the salutary effect of preventing those who have knowledge of the impending offer from taking advantage of that knowledge before announcement of the offer. See *SEC v. Sorg Printing Co.*, [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,767 (S.D.N.Y., filed Aug. 21, 1974), in which the SEC charged a financial printing firm and several of its employees with violations of rule 10b-5 in purchasing shares of the target with knowledge of the impending offer resulting from the printing work done by the firm.

164. [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,424 (N.D. Tex. Jan. 9, 1976).

a list was not a violation, the court ordered the target, which was mailing its own communications to shareholders, to provide the offeror with a list, finding this the best way of informing the target's shareholders of the positions of the offeror and the target's management.¹⁶⁵

While it is clear that for purposes of the Williams Act the term "tender offer" encompasses more than the conventional tender,¹⁶⁶ the Western District of Pennsylvania in its *Copperweld* decision¹⁶⁷ joined the courts rejecting the theory that preconventional tender open-market purchases, without more, constitute a tender offer.¹⁶⁸ Thus, *Copperweld* rejected the argument that pre-tender open-market purchases of an aggregate of over four percent of the target's stock during a three-month period ending more than sixty days prior to the tender constituted a tender offer, even when the offeror intended subsequently to make a conventional tender offer.¹⁶⁹

The Williams Act requires minimum time periods for withdrawal of tendered shares (seven days) and proration (ten days) measured from the date the offer is first published, sent, or given to security holders.¹⁷⁰ The *Copperweld* court held that in computing the minimum time periods the date of publication is not discounted.¹⁷¹ Thus, withdrawal rights with respect to an offer published on the first of the month exist through the seventh.¹⁷²

165. *Id.* at 99, 160-61. In *Crane Co. v. Anaconda Co.*, BNA Sec. Reg. and L. Rep. (N.Y. Feb. 19, 1976), the New York Court of Appeals granted the offeror access to the target's shareholder list, holding that communicating an offer to the target's shareholders is a proper purpose within N.Y. Bus. Corp. Law § 1315 (McKinney 1963).

166. SEC Securities Exchange Act Release No. 8392, (Aug. 30, 1968) (including special bids as tender offers). See *Cattlemen's Investment Co. v. Fears*, 343 F. Supp. 1248 (W.D. Okla. 1972) (active and widespread telephone, mail, and personal solicitations constitute tender offer); *Nachman Corp. v. Halfred, Inc.*, [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,799 (N.D. Ill. 1974). See generally Note, The Developing Meaning of "Tender Offer" under the Securities Exchange Act of 1934, 86 Harv. L. Rev. 1250 (1973). In one interesting case, *Loews Corp. v. Accident & Cas. Ins. Co.*, No. 74 C 1396 (N.D. Ill.) (bench opinion, July 11, 1974), the court held that open market purchases coupled with a publicized intent to acquire a specified percentage of the subject company's shares constituted a tender offer within the Williams Act. Cf. *Leighton v. American Tel. & Tel. Co.*, 397 F. Supp. 133 (S.D.N.Y. 1975).

167. 403 F. Supp. 579 (W.D. Pa. 1975).

168. See, e.g., *D-Z Investment Co. v. Holloway*, [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,771 (S.D.N.Y. 1974); *Gulf & Western Indus., Inc. v. Great Atl. & Pac. Tea Co.*, 356 F. Supp. 1066 (S.D.N.Y.), *aff'd*, 476 F.2d 687 (2d Cir. 1973); *General Host Corp. v. Triumph Am., Inc.*, 359 F. Supp. 749 (S.D.N.Y. 1973); *Water & Wall Associates v. American Consumer Indus.*, [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,913 (D.N.J. 1973).

169. 403 F. Supp. at 597-98.

170. 15 U.S.C. §§ 78n(5), (6) (1970).

171. 403 F. Supp. at 596-97.

172. But see *Petersen v. Federated Dev. Co.*, [Current] CCH Fed. Sec. L. Rep. ¶ 95,620 (S.D.N.Y. June 16, 1976), which held that a Dow Jones "broad tape" announcement started the ten-day period running and that the date of the announcement was excluded from period computation.

*Missouri Portland Cement Co. v. H.K. Porter Co.*¹⁷³ held that a ten-day offer communicated by mailing to a year-old stockholder list and publication of notices (commonly called "tombstones") in a newspaper published in the city where the target's principal office was located and in the Eastern and Midwestern editions of *The Wall Street Journal* was not sufficient to start the time periods running.¹⁷⁴ The opinion contains an implication that were the offer to be open for a longer period, a different result might have been reached.¹⁷⁵ *Commonwealth Oil* declined to hold that a material disclosure amendment of the offer automatically requires that a new seven-day withdrawal period be afforded.¹⁷⁶ Rather, the court as a matter of discretion imposed such a requirement.¹⁷⁷

The question whether management acting in concert to defeat a tender offer constitutes a "group" and is thus required to file a schedule 13D was presented in *Jewelcor, Inc. v. Pearlman*.¹⁷⁸ The court concluded that section 13(d) was applicable, and a schedule 13D was required to be filed by "management groups, especially management groups including non-management members."¹⁷⁹ The court distinguished *Corenco Corp. v. Schiavone & Sons*,¹⁸⁰ on the ground that the *Corenco* management group did not include outsiders but consisted only of management personnel. In addition, the court pointed out that *Corenco* does not mean that management groups are never required to file a schedule 13D, but instead that where an actual tender offer is involved and a management which is opposing it has complied with section

173. No. 75-1027C(A) (E.D. Mo., Nov. 26, 1975).

174. *Id.* at 13-14. In *Advanced Systems, Inc.*, [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,534 (SEC 1973), the SEC staff took the position that it was not unfair to shareholders located in areas other than the midwest when an article concerning the tender offer was published in all editions of the *Wall Street Journal* and a copy of the tender offer was published in the *Chicago Tribune*.

175. No. 75-1027C(A) at 14.

176. 394 F. Supp. at 282, 284-85.

177. See note 192 *infra* and accompanying text.

178. 397 F. Supp. 221 (S.D.N.Y. 1975). In *Twin Fair, Inc. v. Reger*, [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,202 (W.D.N.Y. 1975), the court followed *GAF v. Millstein*, 453 F.2d 709 (2d Cir. 1971), cert. denied, 406 U.S. 910 (1972) in holding that an agreement to act in concert by persons beneficially owning an aggregate of more than five percent of the class of securities is, without more, sufficient for the formation of a group, triggering the schedule 13D filing requirement. In *Bath Industries, Inc. v. Blot*, 427 F.2d 97 (7th Cir. 1970), the court held that there must also be an intention to acquire additional shares for a group to be formed. The SEC has proposed rules which would codify the *GAF* rule, define the term "beneficial ownership," and provide a short form schedule 13D that would be available to certain persons who acquire beneficial ownership in the ordinary course of their business and not for the purpose of affecting control. SEC Securities Act Release No. 5,609; Securities Exchange Act Release No. 11,616 (Aug. 28, 1975).

179. *Id.* at 244.

180. 362 F. Supp. 939 (S.D.N.Y.), *aff'd in part*, 488 F.2d 207 (2d Cir. 1973).

14(d)(4)¹⁸¹ of the Williams Act, management is not required to make a separate schedule 13D filing.¹⁸²

Remedies.—The judicial attitude toward remedies for inadvertent Williams Act violations, as shown by the cases since the beginning of 1975, further reflects the congressional intent that the Williams Act not be used to prevent changes in control, but rather that investors be alerted by appropriate disclosure to the possibility of such changes. Of course, the cases generally follow the congressional intent that control changes should not be accomplished through tender offers unless investors are furnished with sufficient information to enable them to make a reasonable decision whether or not to tender.¹⁸³

The leading case in the remedy area is the Supreme Court's decision in *Rondeau v. Mosinee Paper Corp.*¹⁸⁴ In *Rondeau* the defendant, claiming ignorance of the Williams Act filing requirements, filed his schedule 13D three months after accumulating over five percent of the issuer's stock. The schedule 13D, which was filed only after the issuer notified defendant that his purchases raised questions under the securities laws, disclosed that the shares were originally purchased for investment and also made clear defendant's intention to acquire additional shares for the purpose of exercising control. The schedule, while tardy, accurately reflected the information required to be disclosed. The Court held that an injunction prohibiting the defendant from voting or pledging the acquired shares, from acquiring additional shares, and requiring divestiture of the shares, was not the appropriate remedy since the failure was cured by the subsequent filing and did not result in "irreparable harm."¹⁸⁵

The Court rejected the argument that the injunction was necessary to protect the interests of stockholders who had sold their stock at pre-disclosure prices not knowing a takeover bid was imminent, or those who would not have invested had they known the bid was imminent.¹⁸⁶

181. 15 U.S.C. § 78n(d)(4) (1970). Rule 14(d)(4), 17 C.F.R. § 240.14d-4 (1976), prohibits a recommendation to accept or reject a tender offer unless the person making it has first filed a schedule 14D. Rule 14d-2(f), id. § 240.14d-2(f), permits management to respond to a surprise offer before filing a schedule 14D if management does no more than state it is studying the offer and request that security holders defer decision until management makes its recommendation. See *Anaconda Co. v. Crane Co.*, [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,364 (S.D.N.Y. 1975).

182. 397 F. Supp. at 243-44.

183. See note 124 *supra*.

184. 422 U.S. 49 (1975).

185. Id. at 58-60.

186. Id. at 59. The Court stated:

The short of the matter is that none of the evils to which the Williams Act was directed has occurred or is threatened in this case. Petitioner has not at-

Noting that it was questionable whether this type of "harm" is redressable under the Williams Act, the Court stated that, in any event, persons who sold at the predisclosure prices would have an adequate remedy through a damage action and that persons who invested without knowledge of an impending takeover bid are not likely to be damaged.¹⁸⁷ The court also rejected arguments that the public interest requires an injunction be granted in favor of the issuer because it is in the best position to insure compliance with the Williams Act by purchasers of its stock.¹⁸⁸

In *Klaus v. Hi-Shear Corp.*,¹⁸⁹ the Ninth Circuit interpreted *Rondeau* as requiring that injunctive relief not issue under the Williams Act unless the conduct complained of results in harm to the offerees as distinguished from the offeror.¹⁹⁰ Accordingly, the Court refused to enjoin the voting of shares of the target held by the target's subsidiary, even though the target had reported such shares as target-company-owned (which would have made them nonvotable), and the offeror had relied to his detriment on such report in determining the number of shares to purchase in order to secure control of the target. Using the same rationale, the court also refused to enjoin the voting of shares which were transferred by the target to an employee stock ownership plan and shares which were used by the target to acquire other companies, all for the purpose of increasing the number of and disbursing the outstanding shares in order to thwart the offeror's attempt to acquire control.¹⁹¹

tempted to obtain control of respondent, either by a cash tender offer or any other device. Moreover, he has now filed a proper Schedule 13D, and there has been no suggestion that he will fail to comply with the Act's requirement of reporting any material changes in the information contained therein . . .

Id. at 59-60.

187. *Id.* at 60.

188. *Id.* at 62-63. See also *Stecher-Traung-Schmidt Corp. v. Self*, 529 F.2d 567 (2d Cir. 1976).

In *Missouri Portland Cement Co. v. H.K. Porter Co.*, 535 F.2d 388 (8th Cir. 1976), the court stated that if pre-formal tender offer purchases were deemed tender offers in violation of the Williams Act, shareholders who sold before the tender offer have an adequate remedy of damages, and the target is therefore not entitled to injunctive relief. *Id.* at 399.

189. 528 F.2d 225 (9th Cir. 1975).

190. *Id.* at 232.

191. *Id.* But see *Anaconda Co. v. Crane Co.*, [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,364 (S.D.N.Y. 1975), which indicates that an acquisition by a target designed solely to create an antitrust block to an exchange offer may be a violation of § 14(e). See also *Grossman, Faber & Miller P.A. v. Cable Funding Corp.*, [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,913 (D. Del. 1974), which held that a target company management which engages in conduct to defeat one tender offer and ensure the success of another for personal reasons rather than the best interests of the target and its shareholders may violate rule 10b-5. The complaint in *SEC v.*

The courts have generally continued to follow the view, which would now appear mandated by *Rondeau*, of permitting the offer to go forward once appropriate corrective disclosures have been made. As a corollary, however, the courts also require that shareholders who have tendered before the corrective disclosures be given the opportunity to withdraw tendered shares in view of the new disclosures.¹⁹² In *Otis Elevator Co. v. United Technologies Corp.*,¹⁹³ however, in view of the confusion caused by three prior unilateral amendments of the tender offer and doubts as to whether such amendments re-started the seven-day withdrawal period, the existing offer, which contained disclosure violations, was enjoined. The court left the offeror free to initiate a new offer.¹⁹⁴ The *Otis Elevator* injunction, as opposed to the amendment and extension of the withdrawal right concept employed in other cases, may create a practical problem for the offeror since it involves the return of previously tendered shares and may give the target additional time to muster its defenses.¹⁹⁵

In the most recent round of the litigation involving the fight for control of Piper Aircraft Corporation, the Second Circuit, in *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*,¹⁹⁶ held that the damages to be awarded to the defeated contender for control of a target, where the competing corporation gained control through Williams Act violations, is the difference between the price paid by the defeated contender for its target company stock and the price it could have obtained through sale of such stock through a public offering after the competing corporation unlawfully gained control.¹⁹⁷ Certiorari has been granted¹⁹⁸ and in addition to the question of the measure of damages, among the issues raised are whether a defeated offeror in a takeover contest has an implied right of action for damages under section 14(e). The imminent Supreme

Thermal Power Co., [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,265 (D.D.C. 1975), alleged that the target, a prospective merger partner, and the respective presidents of each violated the antifraud rules by failing to disclose that the main purpose of their agreement to sell a block of stock to the merger partner was to defeat a competing cash tender offer for the target.

192. See, e.g., *Commonwealth Oil Ref. Co. v. Tesoro Petroleum Corp.*, 394 F. Supp. 267 (S.D.N.Y. 1975); *Corenco Corp. v. Schiavone & Sons*, 362 F. Supp. 939 (S.D.N.Y.), *aff'd in part*, 488 F.2d 207 (2d Cir. 1973); *Texasgulf, Inc. v. Canada Dev. Corp.*, 366 F. Supp. 374 (S.D. Tex. 1973).

193. 405 F. Supp. 960 (S.D.N.Y. 1975).

194. *Id.* at 974.

195. *Commonwealth Oil Ref. Co. v. Tesoro Petroleum Corp.*, 394 F. Supp. at 274-75 n.1, and *Jewelcor, Inc. v. Pearlman*, 397 F. Supp. at 252-53, indicate that it may be appropriate for management to attempt to delay completion of a tender offer in order to gain time to negotiate a defensive merger.

196. 516 F.2d 172 (2d Cir. 1975), *cert. granted*, 96 S. Ct. 1505 (1976) (No. 75-353).

197. *Id.* at 190.

198. 96 S. Ct. 1505 (1976) (No. 75-353).

Court decision in *Chris-Craft* promises to be a landmark opinion on at least some of the major issues under the Williams Act.

IV

GOING PRIVATE

The "going private"¹⁹⁹ phenomenon has recently received substantial attention from the federal courts. The most dramatic decisions were those of the Second Circuit in February, 1976 in *Marshel v. AFW Fabric Corp.*²⁰⁰ and *Green v. Santa Fe Industries, Inc.*²⁰¹ Prior to these decisions, it was generally thought, with limited deviation in the case law,²⁰² that the question of whether a corporate transaction was fair did not present a federally cognizable question, but that the only appropriate question under federal securities laws concerning going private transactions was whether full disclosure had been made.²⁰³ In addition to provoking *Marshel*, *Green*, and numerous other court decisions, the going private trend has received significant federal regulatory attention, and the SEC has proposed rules to deal with going private transactions.²⁰⁴

The Marshel Case.—*Marshel*, an action to enjoin the conversion of Concord Fabrics, Inc., into a privately held company, presented an unappealing set of facts to a court applying equitable principles. Concord made its initial public offering at \$15 per share, and shortly thereafter its insiders sold shares to the public at \$20 per share. Several years later, with Concord stock selling at \$1 per share, Concord's insiders decided to eliminate public ownership by causing Concord to pay the minority \$3 per share. The device to be employed to eliminate the minority ownership was a cash merger of Concord with a new corporation owned by the insiders and formed solely for the purpose of the merger.²⁰⁵

199. "Going private" is the term employed to describe transactions which eliminate the public ownership of a corporation while leaving the insiders or dominant parent as the surviving equity holders.

200. 533 F.2d 1277 (2d Cir. 1976), vacated and remanded for mootness determination, 45 U.S.L.W. 3279 (U.S. Oct. 6, 1976).

201. 533 F.2d 1283 (2d Cir. 1976), cert. granted, 45 U.S.L.W. 3249 (U.S. Oct. 4, 1976) (No. 75-1753).

202. See, e.g., *IIT v. Vencap, Ltd.*, 519 F.2d 1001 (2d Cir. 1975); *Drachman v. Harvey*, 453 F.2d 722 (2d Cir. 1972) (en banc); *Schoenbaum v. Firstbrook*, 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 906 (1969).

203. See, e.g., *Popkin v. Bishop*, 464 F.2d 714 (2d Cir. 1972); *Broder v. Dane*, 384 F. Supp. 1312 (S.D.N.Y. 1974); *Dreier v. Music Makers Group, Inc.*, [1973-74 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,406 (S.D.N.Y. 1974); *Kaufman v. Lawrence*, 386 F. Supp. 12 (S.D.N.Y. 1974); *Levine v. Biddle Sawyer Corp.*, 383 F. Supp. 618 (S.D.N.Y. 1974); *Scott v. Multi-Amp Corp.*, 386 F. Supp. 44 (D.N.J. 1974). See note 210 *infra* and accompanying text.

204. See notes 236-41 *infra* and accompanying text.

205. 533 F.2d at 1279-80.

The transaction was structured and administered from its inception by the insiders, who would have owned the entire equity interest in Concord upon a successful consummation of it. The investment banker whose opinion was the basis for the take-out price was of dubious independence.²⁰⁶ The take-out price was substantially less than the book value per share and the price at which shares were offered to the public a few years earlier. The transaction was to be financed with Concord's own assets.²⁰⁷ No opportunity for any participation in setting the terms of the transaction was afforded to the minority shareholders, either directly or through a representative. In view of the number of Concord shares owned by the insiders, the transaction would have been approved by the requisite statutory vote irrespective of how the minority voted.²⁰⁸ There was admittedly no purpose for the transaction other than to eliminate the public's ownership of Concord.²⁰⁹

The district court in *Marshall*, holding that the fairness of a transaction did not raise a federal question since full and complete disclosure had been made, stated:

Plaintiffs' claims that there has been a Rule 10b-5 violation because of the unfair and inadequate price to be paid for the Concord shares and the absence of a bona fide corporate purpose for the merger are patently without merit. Rule 10b-5 simply does not encompass these alleged wrongs.²¹⁰

The Second Circuit, in reversing the district court's holding with respect to rule 10b-5, responded:

What this purported "merger" amounts to is a scheme by the [insiders], having previously taken advantage of public financing, to appropriate for their personal benefit the entire stock ownership of Concord at a price determined by them and paid out of the corporate treasury We hold that when controlling stockholders and directors of a publicly-held corporation cause it . . . to force elimination of minority stockholders' equity participation for reasons

206. See *People v. Concord Fabrics, Inc.*, 83 Misc. 2d 120, 121, 371 N.Y.S.2d 550, 551 (Sup. Ct.), *aff'd*, 50 App. Div. 2d 787, 377 N.Y.S.2d 84 (1st Dep't 1973), another action to enjoin the merger brought by the state attorney general, discussed in note 211 *infra*.

207. *Id.*

208. For the impact of this fact with regard to materiality and causation under rule 10b-5, see *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975).

209. 533 F.2d at 1279.

210. 398 F. Supp. 734, 738 (S.D.N.Y. 1975), *rev'd*, 533 F.2d 1277 (2d Cir. 1976), vacated and remanded for mootness determination, 45 U.S.L.W. 3279 (U.S. Oct. 6, 1976).

not benefiting the corporation but rather serving only the interests of the controlling stockholders such conduct will be enjoined pursuant to Section 10(b) and Rule 10b-5²¹¹

The Second Circuit rejected the argument of the Concord insiders that the absence of any corporate purpose was irrelevant since the proposed merger would comply in all respects with the merger sections of the New York Business Corporation Law.²¹² Under that law, appraisal rights are the exclusive remedy provided for dissenting shareholders.²¹³ The court held that the existence of the state appraisal remedy did not negate the plaintiffs' rights under federal law.²¹⁴

The Green Case.—Only a few days after *Marshall*, the Second Circuit, in *Green v. Santa Fe Industries, Inc.*,²¹⁵ held that a typical short-form cash merger unaccompanied by a "justifiable corporate purpose" and

211. 533 F.2d at 1280-81. For the text of rule 10b-5, see note 53 supra.

The Second Circuit's obvious distaste for the Concord going private plan was shared by a New York Supreme Court and the New York Attorney General. Less than two weeks prior to the federal district court decision in *Marshall*, the state Supreme Court, in *People v. Concord Fabrics, Inc.*, 83 Misc. 2d 120, 371 N.Y.S.2d 550 (Sup. Ct.), aff'd, 50 App. Div. 2d 787, 377 N.Y.S.2d 84 (1st Dep't 1975), granted the New York Attorney General, in an action under the Martin Act (the New York "Blue Sky Law"), a temporary injunction to prevent Concord from going private. The court did not reach any substantive issues, finding that "[t]he sole issue . . . is whether the State has an interest in investigating and seeking to have vitiated a proposed merger or freeze out of minority stockholders . . ." Id. at 122, 371 N.Y.S.2d at 552. The court, however, did not refrain from reflecting its attitude toward the transaction:

What is disquietingly evident here is the fact that a group of insiders who are directing the reacquisition program, even controlling the appraisal of the stock, are the very ones who made the company public originally, and will be the surviving shareholders in the proposed privately-held enterprise. Adding to the odium of the scheme is the fact that no real corporate purpose has been demonstrated and that the credit of a now public corporation will be used to finance a merger for the benefit of a private group.

Id. at 125, 371 N.Y.S.2d at 554.

212. N.Y. Bus. Corp. Law § 901 (McKinney 1963), as amended, (McKinney Supp. 1975).

213. See, e.g., *Blumenthal v. Roosevelt Hotel, Inc.*, 202 Misc. 998, 115 N.Y.S.2d 52 (Sup. Ct. 1952). The New York Court of Appeals reaffirmed this proposition implicitly in *Endicott Johnson Corp. v. Bader*, 37 N.Y.2d 585, 333 N.E.2d 614, 376 N.Y.S.2d 103 (1975).

214. 533 F.2d at 1281. See also several post-1974 state cases preventing going private mergers: *Berkowitz v. Power/Mate Corp.*, 135 N.J. Super. 36, 342 A.2d 566 (Ch. Div. 1975), and *Jutkowitz v. Bourns*, No. CA 000268 (Cal. Super. Ct., Los Angeles Co., Nov. 19, 1975). Both cases involved going private mergers similar to that involved in *Marshall*. *Berkowitz*, in enjoining the going private merger, rejected the argument that since a damage remedy was available to the minority, injunctive relief was unwarranted. 135 N.J. Super. at 50, 342 A.2d at 574. *Jutkowitz* prevented a going private merger and in effect held that, notwithstanding the adequacy of the take-out price, a shareholder has the right to retain his shares. No. CA 000268 at 4.

215. 533 F.2d 1283 (2d Cir. 1976), cert. granted, 45 U.S.L.W. 3249 (U.S. Oct. 4, 1976) (No. 75-1753).

at an inadequate price constituted a per se violation of rule 10b-5. The plaintiffs in *Green* had been minority shareholders of a Delaware corporation, ninety-five percent of the capital stock of which had been owned by a wholly-owned subsidiary of Santa Fe. A new corporation was organized and the ninety-five percent interest was transferred to it. The new corporation was then merged into the Delaware corporation with the minority shareholders to receive \$150 cash per share (based upon the opinion of an independent investment banker) or seek their state law appraisal rights. As required by Delaware law, the minority shareholders received a notice advising them of the consummation of the merger, their rights thereunder, and other detailed financial information.²¹⁶

Plaintiffs in *Green* asserted that the merger constituted a manipulative and deceptive device within the meaning of rule 10b-5 because (a) the take-out price was inadequate (based in part upon information in the notice that the appraisal value of each of their shares was in excess of \$700), (b) the merger had no corporate purpose other than forcibly to eliminate the minority equity interest, and (c) the failure to disclose the merger prior to its consummation deprived them of their opportunity to obtain injunctive relief. The Second Circuit agreed with plaintiffs and again overruled the lower court's holding that a cause of action under the rule required misrepresentation or lack of disclosure:

Whether full disclosure has been made is not the crucial inquiry since it is the merger and the undervaluation which constitute the fraud, and not whether or not the majority determines to lay bare their real motives. If there is no valid corporate purpose for the merger, then even the most brazen disclosure of that fact to the minority shareholders in no way mitigates the fraudulent conduct.²¹⁷

The *Green* holding is particularly significant. Unlike *Marshall*, which presented an egregious set of facts—insiders taking a company public at a high price and private at a low price—*Green* involved a situation for which the short-form merger statutes were specifically

216. *Id.* at 1287-88.

217. *Id.* at 1292. The fact that Delaware law provided for no notice also played a part in the court's holding:

[W]e do not now hold that an allegation of substantial undervaluation, standing alone, makes out a Rule 10b-5 case in a Delaware short-form merger setting. We deal here with the additional elements of lack of a justifiable corporate purpose for the merger and the fact that the Delaware law provides for no prior notice to the minority shareholders thus depriving them of the opportunity to apply for injunctive relief, as well as the allegations of undervaluation.

Id. at 1292.

designed.²¹⁸ As pointed out by Judge Moore in an acrimonious and well-reasoned dissent,²¹⁹ the holding in *Green* seems to be an unwarranted intrusion of federal law into an area which has historically been thought to be the domain of state corporate law—the regulation of the internal affairs of corporations.²²⁰

Subsequent to Marshel and Green.—In *Merrit v. Libby, McNeill & Libby*,²²¹ the Second Circuit shed further light on the scope of its holdings in *Marshel* and *Green*. *Merrit* involved a motion for a preliminary injunction to prevent a short-form cash merger of a ninety-two percent-owned subsidiary. The merger had been announced by the parent corporation in a prior tender offer for the subsidiary and in a prior notice to shareholders under state law.²²² The *Merrit* court, in declining to reverse the denial of a preliminary injunction, distinguished *Marshel* on the grounds that in *Marshel* there was no business purpose for the merger other than elimination of the minority, corporate funds were to be used for the freeze-out, and the insiders were attempting to take advantage of going public at a high price and private at a low price.²²³ The court distinguished *Green* on the ground that it involved a motion to dismiss the complaint and was therefore presumably based on the allegation that the short-form merger there involved was unfairly priced and without any business purpose.²²⁴

In *Nash v. Farmers New World Life*²²⁵ the United States District Court for the Southern District of Ohio refused to hold a short-form merger to be a violation of rule 10b-5. The court found that (1) the take-out price was fair, (2) the purpose of the merger was not solely to eliminate the minority, (3) the merger was approved by more than seventy-five percent of the minority (although the minority did not have the power to determine the merger), (4) there was no sequence of going public high and private low as in *Marshel*, and (5) the shareholders had prior notice of the merger.²²⁶

218. See, e.g., *David J. Greene & Co. v. Schenley Indus., Inc.*, 281 A.2d 30 (Del. Ch. 1971); *Stauffer v. Standard Brands, Inc.*, 41 Del. Ch. 7, 187 A.2d 78 (1962); E. Folk, *The Delaware General Corporation Law: A Commentary and Analysis* 352 (1972); Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right*, 77 Harv. L. Rev. 1189, 1200 (1964).

219. 533 F.2d at 1307.

220. *Green* was followed by *Box v. Northrop Corp.*, 74 Civ. 4373 (S.D.N.Y. Feb. 26, 1976), which denied a motion to dismiss a rule 10b-5 claim in connection with a short-form merger. See also notes 234-35 *infra* and accompanying text.

221. 533 F.2d 1310 (2d Cir. 1976).

222. *Id.* at 1311.

223. *Id.* at 1312-13.

224. *Id.* at 1312.

225. [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,519 (S.D. Ohio Mar. 30, 1976).

226. *Id.* at 99,660-61.

In *Marsh v. Armada Corp.*,²²⁷ decided approximately two months after *Marshel* and *Green*, the Sixth Circuit rendered its view of the Second Circuit opinions. *Marsh* involved a tender offer acquisition of in excess of fifty percent of the target's stock, with the offer stating that if control were acquired, the target's dividend would be eliminated and the offeror would seek to acquire the remaining public interest in the target through a merger.²²⁸ The plaintiffs asserted that the omission of the dividend was a breach of fiduciary duty and constituted a fraudulent scheme to reduce the price of the target's stock so the merger could be effected at a reduced price. Accordingly, the essence of the plaintiff's claims was the fairness of the merger terms.

The Sixth Circuit distinguished *Marshel* and *Green* on the ground that in those cases the merger itself was attacked as a fraudulent scheme, and instead relied on the Second Circuit's opinion in *Popkin v. Bishop*²²⁹ where only the fairness of the merger was attacked.²³⁰ The Sixth Circuit concluded that "when the shareholders allege that the terms of a merger are not only unfair but fraudulent but do not challenge the purpose of a merger they must allege deception as required by *Popkin*" in order to sustain a rule 10b-5 claim.²³¹ Accordingly, the Sixth Circuit declined to equate breach of fiduciary duty with fraud:

227. 533 F.2d 978 (6th Cir. 1976), petition for cert. filed, 45 U.S.L.W. 3011 (U.S. July 6, 1976) (No. 76-5).

228. *Id.* at 980.

229. 464 F.2d 714 (2d Cir. 1972).

230. See also *Lynch v. Vickers Energy Corp.*, 351 A.2d 570 (Del. Ch. 1976), in which the court rejected the argument that a tender offer by a parent company for its 53.5% owned subsidiary, which offer stated that if widely accepted the liquidity of the subsidiary's stock would be adversely affected, was coercive and therefore the equivalent of a cash merger entitling the minority to appraisal rights under Delaware law.

In *Bertozi v. King Louie Int'l.*, Civ. No. 76-0158 (D.R.I. May 3, 1976), the court enjoined a going private tender offer on the basis that *Marshel* and *Green* established that the coercive tender offer theory is inherent in rule 10b-5, while in *Raffa v. Mechanics Bldg. Mat. Co.*, [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,535 (E.D.N.Y. April 28, 1976) the opposite result was reached. Compare *Kaufman v. Lawrence*, 514 F.2d 283 (2d Cir. 1975), discussed in note 231 *infra*.

231. 533 F.2d at 986. Cases finding a valid corporate purpose for elimination of the minority include *Grimes v. Donaldson, Lufkin & Jenrette, Inc.*, 392 F. Supp. 1393 (N.D. Fla. 1974); *Tanzer Economic Associates, Inc. v. Universal Food Specialties, Inc.*, 383 N.Y.S.2d 472 (Sup. Ct. 1976); and *Schulwolf v. Cerro Corp.*, 380 N.Y.S.2d 957 (Sup. Ct. 1976). These three cases each involved a combination of operating companies and not merely "form only" mergers of the type involved in *Marshel*. Both *Universal Food* and *Cerro*, which were state law cases decided after *Marshel* and *Green*, refused to enjoin mergers following tender offer acquisitions. In both cases, the merger prices were based on opinions of prominent independent investment bankers. *Universal Food* distinguished *Marshel* on several grounds, among them a valid corporate purpose and the absence of a going public and private high-low sequence. *Green* was distinguished on the ground that *Green*, in considering a motion to dismiss, assumed inadequacy of price and lack of business purpose, and that in *Green* there

Although fraud by directors usually is also a breach of fiduciary duty, a breach of fiduciary duty in formulating the terms of a merger does not itself raise a Rule 10b-5 claim; to hold otherwise is to provide a federal forum for all shareholders dissatisfied with the terms of a proposed merger, which is not the intent of § 10(b) of the Exchange Act.²³²

The strength of the *Marshall* and *Green* holdings is questionable in view of the Supreme Court's obvious predilection for not expanding the scope of the federal securities laws.²³³ In addition, the Supreme Court's recent opinion in *Cort v. Ash*,²³⁴ a nonfederal securities case, may portend the Court's reluctance to entertain suits to vindicate what may be viewed as state law fiduciary obligations, brought in the guise of federal claims. The Court stated:

Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of a corporation.²³⁵

Proposed Rule 13e-3.—The SEC has proposed rules on going private transactions.²³⁶ Proposed rules 13e-3A and 13e-3B would in effect implement the holdings in *Green* and *Marshall* by requiring "fairness" to shareholders as well as substantive disclosures. The SEC's proposal contains two alternative rules. Implicitly in the first proposal and explicitly in the second, if the going private transaction is not fair it will be deemed a fraudulent, deceptive, or manipulative act or practice.

was no prior notice of the merger so that the minority had no opportunity to seek injunctive relief. The *Universal Food* court rejected the per se proscription of "freeze outs" adopted in *Jutkowitz v. Bourns*, CA 000268 (Cal. Super. Ct., Los Angeles Co., Nov. 19, 1975) (discussed in note 214 supra), and in effect found that state law appraisal rights should be supplemented with consideration of injunctive relief only if there is no business purpose for the "freeze out." The *Cerro* court also found it significant that in addition to a valid purpose, the terms of the merger were approved by a committee of independent directors and minority shareholders and that the acquiring parent had agreed to vote its shares for approval only if a majority of the publicly-held shares so voted. See also *Kaufman v. Lawrence*, 514 F.2d 283 (2d Cir. 1975), in which the Second Circuit, in a per curiam affirmance, upheld the district court's refusal to enjoin a company's exchange offer for its own stock, the stated aim of which was to eliminate public ownership. The district court noted that there did not appear to be a large number of shareholders opposed to the offer, and that "[i]f such opposition does exist, defendant's plans to go 'private' will be frustrated by a sizeable number of shareholders refusing to tender their shares." 386 F. Supp. 12, 17 (S.D.N.Y. 1974).

232. 533 F.2d at 984.

233. See notes 53-100 supra and accompanying text.

234. 422 U.S. 66 (1975).

235. Id. at 84.

236. Securities Act Release No. 5567 (Feb. 6, 1975).

The first proposal would require that the consideration paid to the minority shareholders be no less than that jointly recommended by at least two qualified independent appraisers. The second alternative proposal would require the issuer to have a valid business purpose for the transaction and would create a general fairness requirement. Transactions covered by the proposed rule include the conventional mechanisms of forcibly taking out minority interests in whole or in part, as well as transactions which would have the effect of causing the securities of a listed corporation to be delisted, terminating the registration of the issuer under section 12(g) of the Securities Exchange Act of 1934,²³⁷ or suspending the reporting obligations of the issuer under section 15(d) of the 1934 Act.²³⁸ In addition, one of the alternative proposals would also include as a subject transaction any transaction by the issuer or its affiliate which would reduce by twenty-five percent or more the amount of any class of equity security outstanding.²³⁹

Under both the alternative proposals the issuer would be required at least twenty days prior to any covered transaction to send to its shareholders a notice containing detailed information, which would also have to be filed with the SEC.²⁴⁰ The proposals also contain requirements relating to withdrawal rights and proration in tender offers. In addition, the proposals in certain instances require the issuer to notify the remaining shareholders of the result and effect of the transaction, and to offer to purchase their remaining shares for the same consideration as in the transaction.²⁴¹

V

SHORT SWING PROFITS

In the third section 16(b)²⁴² case decided by the Supreme Court within the last four years, the Court, in *Foremost-McKesson, Inc. v.*

237. 15 U.S.C. § 781 (1970).

238. *Id.* § 78m.

239. The logical justification for inclusion of these transactions within the ambit of the proposed rule is presumably that in certain circumstances the destruction of the liquidity of the market for the shares being repurchased may constitute a breach of a fiduciary duty by the insiders to the nontendering shareholders, or may constitute a breach of an implied warranty by the issuer made at the time it went public. See *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); *United Funds, Inc. v. Carter Prod., Inc.*, [1961-64 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,288 (Cir. Ct. Baltimore City, Md. 1963); *First of Michigan Corp.*, [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,401 (SEC Mar. 29, 1973); *House of Adler, Inc.*, [1971-72 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,515 (SEC Sept. 30, 1971).

240. Securities Act Release No. 5567 (Feb. 6, 1975).

241. *Id.*

242. Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) (1970). Corporate insiders, whose trading is regulated by § 16(b), are defined in § 16(a), 15 U.S.C. § 78p(a) (1970), as

Provident Securities Co.,²⁴³ again declined to impose section 16(b) liability in a situation where the transaction easily could have been held within the reach of the statute. *Foremost-McKesson* arose out of the sale by Provident Securities Company (Provident) of approximately two-thirds of its assets to Foremost-McKesson, Inc. (Foremost), in exchange for cash and convertible debentures of Foremost. The debentures were convertible into more than ten percent of Foremost's outstanding common stock and were resold within two weeks after their receipt. In view of its ten percent equivalent holdings²⁴⁴ and the purchase and sale within six months, Provident sought a declaratory judgment that it was not liable to Foremost for the profit made on the sale. Foremost counter-claimed to recover the short swing profit.

The Court held that the purchase by which Provident acquired its ten percent interest could not be matched against the subsequent sale for the purpose of imposing section 16(b) liability. The decision was based on a construction of the last sentence of section 16(b), which exempts from the statute's application transactions in which the ten percent holder "was not such both at the time of the purchase and sale, or the sale and purchase." The Court held that in a purchase-sale sequence the exemptive provision's phrase "at the time of the purchase" should be read as meaning "before the purchase."²⁴⁵ This conclusion was reached primarily from an analysis of the statute's admittedly sparse legislative history, where, from the evolution of section 16(b) through its various proposed versions in the Congress, the Court found persuasive evidence for its construction.²⁴⁶

Significantly, and in language that clearly reflects the Court's at-

[e]very person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security . . . which is registered pursuant to Section 78(1) of this title, or who is a director or an officer of the issuer of such security

Section 16(b) provides in part:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer This sub-section shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved

243. 423 U.S. 232 (1976). The other two cases are *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973) and *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418 (1972).

244. Rule 16a-2(b), 17 C.F.R. § 240.16a-2(b) (1975), includes within beneficial ownership those securities "which such person has the right to acquire through the exercise of presently exercisable options, warrants or rights or through the conversion of presently convertible securities."

245. 423 U.S. at 249-50.

246. *Id.* at 243-51 & nn.24, 26.

titude toward section 16(b), the Court refused to adopt an approach which would impose section 16(b) liability simply because a challenged transaction presents the possibility for abuse of inside information. Rather, the opinion, while noting that ambiguities in the statute should be resolved in favor of the construction that best serves the statute's purpose, indicates that such purposes are not necessarily served by resolving every ambiguity in favor of liability. Liability, according to the Court, should only be imposed if a strict reading of the statute and its history indicates that the transaction was of the type Congress sought to cover:

It is inappropriate to reach the harsh result of imposing § 16(b)'s liability without fault on the basis of unclear language. If Congress wishes to impose such liability, we must assume it will do so expressly or by unmistakable inference [C]ourts should not be quick to determine that, despite an acknowledged ambiguity, Congress intended the section to cover a particular transaction.²⁴⁷

As support for its construction, the Court referred to the fact that Congress obviously believed all short-term trading by officers and directors, without regard to the size of their holdings, was subject to possible abuse because of the involvement such persons necessarily have in corporate affairs. Trading by mere stockholders, the Court found, was viewed as offering the possibility of abuse only when the holdings were of a size that afforded the opportunity for access to inside information. While one who becomes a ten percent holder might sell on the basis of inside information acquired by virtue of his holdings, the Court found that this was not a danger which Congress considered "intolerable" so as to warrant section 16(b)'s automatic liability, since the purchase would have been made at a time when the purchaser's holdings were insufficient to afford the presumed access. Finally, the Court noted that Congress had left some problems of inside information abuse to other remedies, such as the antifraud provisions of the federal securities laws.²⁴⁸

247. *Id.* at 252. Compare *Kern County Land Co. v. Occidental Petroleum Co.*, 411 U.S. 582 (1973), which involved the conversion of shares acquired by a hostile tender offeror to shares of a surviving company in a defensive merger and the grant to the surviving company of an option to purchase the converted shares. *Kern County*, noting that the insider was not an active or necessary participant in the defensive merger and that the option was, in effect, a call, held that in the "unorthodox" factual context of the case there was no possibility of speculative abuse and that neither the conversion of shares upon the merger nor the option constituted a "sale" for § 16(b) purposes. 411 U.S. at 596-604. Compare *Kramer v. Ayer*, [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,483 (S.D.N.Y. Mar. 22, 1976).

248. 423 U.S. at 255 & n.29.

Approximately four years before its *Foremost-McKesson* decision, the Supreme Court, in *Reliance Electric Co. v. Emerson Electric Co.*,²⁴⁹ another purchase-sale sequence, considered the meaning of the phrase "at the time of . . . sale" contained in the exemptive provision. There, the Court, accepting a "split sale" device, held that a disposition of stock by a ten percent holder which reduces the seller's interest to just less than ten percent is a separate transaction from the later disposition of the seller's remaining interest. Section 16(b) liability does not attach to the later disposition because at the time of such disposition the seller was not a ten percent holder.²⁵⁰

The Supreme Court's *Foremost-McKesson* construction of the exemptive provision in the last sentence of section 16(b) was carefully limited to a purchase-sale sequence and expressly left open the question of the proper application of the exemptive provision in the sale-repurchase context²⁵¹—the situation where a ten percent holder reduces his holdings to less than ten percent and then repurchases additional shares. Similarly, *Reliance Electric* did not consider the sale-repurchase situation. In *Allis-Chalmers Manufacturing Co. v. Gulf & Western Industries, Inc.*,²⁵² decided before the Supreme Court's *Foremost-McKesson* opinion, the Seventh Circuit adopted a construction of the exemptive provision which would make it applicable only if the ten percent holder was not a ten percent holder immediately before the first step in either a purchase-sale or sale-repurchase sequence.²⁵³ Under the *Allis-Chalmers* formulation, a ten percent holder who reduces his ownership by sale to less than ten percent can not repurchase within six months of such sale without incurring section 16(b) liability for his short swing profit. While in *Foremost-McKesson* the Supreme Court indicated in a footnote that section 16(b) liability was "possible" in such a situation,²⁵⁴ it is doubtful that the Court, given its decision in *Reliance Electric* and in view of its requirement that the statute be read strictly before no-fault liability can be imposed, would reach the same decision in the sale-repurchase context as did the *Allis-Chalmers* court.

In *Lewis v. Mellon Bank, N.A.*,²⁵⁵ the Third Circuit refused to extend the rule established in *Feder v. Martin Marietta Corp.*,²⁵⁶ that a

249. 404 U.S. 418 (1972).

250. *Id.* at 419-20. Since Emerson Electric was not a 10% holder before its tender offer acquisition of 13.2% of the shares of Reliance Electric, under the holding of *Foremost-McKesson* no § 16(b) liability would have attached to either of Emerson's sales. See 423 U.S. at 250 n.25.

251. 423 U.S. at 242-43 & nn.15-16.

252. 527 F.2d 335 (7th Cir. 1975), cert. denied, 423 U.S. 1078 (1976).

253. *Id.* at 348 & n.13.

254. 423 U.S. at 241 n.12.

255. 513 F.2d 921 (3d Cir. 1975).

256. 406 F.2d 260 (2d Cir. 1969), cert. denied, 396 U.S. 1036 (1970).

director will be liable for short swing profits even if he was a director at the time of only the purchase or the sale. In *Lewis*, the director had resigned and did not hold office at the time of either the purchase or the sale. Within two days after his retirement, he exercised a stock option²⁵⁷ and on the day of exercise sold the stock so acquired. The Third Circuit, while recognizing the possibilities for abuse inherent in such a situation, declined to impose liability, holding that section 16(b) applies to a director only if he held that position at the time of the purchase or the sale, or both.²⁵⁸

Whiting v. Dow Chemical Co.,²⁵⁹ decided by the Second Circuit, involved the question whether the sale by a wife of a portion of her separate holdings can be matched against a subsequent purchase by her director husband for the purpose of imposing section 16(b) liability on the husband. The Second Circuit held that if the director husband was the "beneficial owner" of the shares sold by his spouse, liability will attach. Moreover, exclusive control of the spouse's shares is not necessary for a finding of beneficial ownership, which must be determined by all of the surrounding facts. The *Whiting* court concluded that beneficial ownership did exist, based on its analysis of the manner in which the family's investments were made, the fact that income and expenses were shared, and the lack of disclaimer of beneficial ownership in the required SEC filings.²⁶⁰

Other cases of significance, but perhaps having a narrower application than those noted above, involved the meaning of "purchase" for purposes of section 16(b), the timing of transactions, the valuation of noncash consideration for purposes of computing profits, and the medium of repayment of section 16(b) liability. *Abbe v. Goss* held that the acquisition of shares pursuant to a divorce decree does not constitute a purchase,²⁶¹ and *Morales v. Reading & Bates Offshore Drilling Co.* held that initiation of the paperwork to exercise an option does not constitute a purchase since that step did not create an "irrevocable liability to pay for the stock."²⁶²

In addition, *Morales*, as well as a Second Circuit affirmation of

257. The exercise of an option is a purchase for § 16(b) purposes, with the provisions of rule 16b(6), 17 C.F.R. § 240.16b(6) (1975), operating only to limit the amount of the recovery if options meeting the rule's requirements are involved. *Sonics Int'l, Inc. v. Johnson*, 387 F. Supp. 741, 742 (N.D. Tex. 1975). See rule 16b(3), 17 C.F.R. § 240.16b(3) (1975).

258. 513 F.2d at 925.

259. 523 F.2d 680 (2d Cir. 1975).

260. *Id.* at 688-89.

261. [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,319, at 98,616 (S.D.N.Y. 1975).

262. 392 F. Supp. 41, 45 (N.D. Okla. 1975).

another lower court decision,²⁶³ refused to upset the twenty-year-old rule²⁶⁴ that a purchase or sale followed by a sale or purchase on the last day of a six-month period does not give rise to section 16(b) liability. Rather, it was held that since section 16(b) requires the transactions to take place "within" a period of "less than" six months, liability will attach only if the transactions occur within a period starting at 12:01 A.M. on one day and ending two days prior to the day corresponding numerically to the starting day in the sixth succeeding month. Thus, if a purchase were made on January 1, the sale would have to be made on or before June 29 for liability to attach. Such a "formula takes account of 'within' by excluding one day and 'less than' by excluding an additional one day."²⁶⁵

Allis-Chalmers Manufacturing Co. also held that in arriving at the sales price for the sale component of a section 16(b) transaction, marketable securities constituting a portion of the consideration need not be valued at the highest price at which they traded on the day in question, but instead could be valued on a "volume-weighted average" basis.²⁶⁶ In valuing a note which also constituted a portion of the consideration, it was ruled that no discount from the face amount is permissible if the note is in fact paid in full, notwithstanding that at the time of delivery of the note its market value was less than face amount.²⁶⁷ Finally, *Lewis v. Arkara* held that the obligation to repay a short swing profit to the issuer can only be satisfied by a cash payment, not by delivery of a note.²⁶⁸

VI

SECURITIES LEGISLATION

On June 4, 1975, President Ford signed the Securities Acts Amendments of 1975 (Act).²⁶⁹ While amending all of the statutes administered

263. *Colonial Realty Corp. v. MacWilliams*, 512 F.2d 1187 (2d Cir.), cert. denied, 423 U.S. 867 (1975), aff'g 381 F. Supp. 26 (S.D.N.Y. 1974).

264. Established in *Stella v. Graham-Paige Motors Corp.*, 132 F. Supp. 100 (S.D.N.Y. 1955), remanded on other grounds, 232 F.2d 299 (2d Cir.), cert. denied, 352 U.S. 831 (1956).

265. 392 F. Supp. at 45.

266. 527 F.2d 335, 352-53 & n.19. See notes 252-54 *supra* and accompanying text.

267. 527 F.2d at 356-57.

268. 401 F. Supp. 449, 453 (S.D.N.Y. 1975). Where the profit realized by the insider is taxed as a long-term capital gain, the repayment will be afforded treatment as a long-term capital loss, not as an ordinary and necessary business expense. *Brown v. Commissioner*, 529 F.2d 609 (10th Cir. 1976).

269. Act of June 4, 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified in scattered sections of 15 U.S.C.).

by the SEC, the Act represents a major revision of the Securities Exchange Act of 1934.²⁷⁰ The Act reflects a congressional determination that competition in the securities markets should be encouraged, that information with respect to securities transactions in all markets should be readily available so that orders may be executed in the best market, and that free access to the organizations operating within the securities markets by all qualified persons is crucial to the establishment of free and open competition.²⁷¹ In addition to providing the framework for a National Market System,²⁷² including a national system for the clearance and settlement of securities transactions,²⁷³ the Act makes major changes in the regulation of brokers and dealers,²⁷⁴ including those handling municipal securities.²⁷⁵ Further regulation of national securities exchanges²⁷⁶ and securities associations²⁷⁷ is combined with ex-

270. 15 U.S.C. §§ 77-80 (Supp. V, 1975). Unless otherwise indicated, all section references are to the provisions of the 1934 Act as amended by the Act.

271. See, e.g., §§ 2, 6, 11A, 15, 15A, and 17A of the 1934 Act, 15 U.S.C. §§ 78b, 78f, 78k-1, 78o-3, 78q-1 (Supp. V, 1975). For discussion of the Act and its effects, see Pitt, *The Securities Acts Amendments of 1975*, 174 N.Y.L.J., No. 114, at 1 (Dec. 15, 1975); Rowen, *Securities Acts Amendments of 1975*, 8 Rev. Sec. Reg. 889 (1975). Section 23(a)(2), 15 U.S.C. § 78w(a)(2) (Supp. V, 1975), requires the SEC to consider the effect on competition of any rule adopted under the 1934 Act.

It should be noted that the Act eliminated § 15A(n) of the 1934 Act, 15 U.S.C. § 78o-3(n) (1970), which provided that in the event of a conflict, § 15A(n) prevailed over any other provision of law in effect at the date § 15A(n) was enacted. The section was viewed as a limited antitrust exemption. The Senate Report accompanying S. 249, the Senate version of the Act, states that the deletion of this provision is not designed to change existing law on the relationship between the antitrust and securities laws. S. Rep. No. 75, 94th Cong., 1st Sess. 14 (1975) [hereinafter cited as Senate Report]. See also the Report of the Senate-House Conference Committee on the Act, H.R. No. 229, 94th Cong., 1st Sess. 100 (1975) [hereinafter cited as Conference Report], in which the Conference Committee recognizes a potential conflict but states that the "conferees are confident that the courts can avoid actual conflicts by a flexible use of existing precedents." The application of the antitrust laws to the securities industry in light of the Act and *Gordon v. New York Stock Exch., Inc.*, 422 U.S. 659 (1975) and *United States v. National Ass'n of Sec. Dealers, Inc.*, 422 U.S. 694 (1975) is beyond the scope of this article. For an interesting discussion of this topic, see Baker, *Antitrust Law and Policy in the Securities Industry: A Tale of Two Days in June*, 31 Bus. Law. 743 (1976); Heckman, *Antitrust Immunity*, 8 Rev. Sec. Reg. 841 (1975).

272. See § 11A, 15 U.S.C. § 78k-1 (Supp. V, 1975), and text accompanying notes 287-93 *infra*.

273. See § 17A, 15 U.S.C. § 78q-1 (Supp. V, 1975), and text accompanying notes 306-25 *infra*.

274. See §§ 15, 15B, 15 U.S.C. §§ 78o, 78o-4 (Supp. V, 1975), and text accompanying notes 326-38 *infra*.

275. See §§ 15, 15B, 15 U.S.C. §§ 78o, 78o-4 (Supp. V, 1975), and text accompanying notes 339-50 *infra*.

276. See § 6, 15 U.S.C. § 78f (Supp. V, 1975), and text accompanying note 351 *infra*.

277. See § 15A, 15 U.S.C. § 78o-3 (Supp. V, 1975), and text accompanying note 351 *infra*.

pansion of the authority of the SEC to oversee their operations.²⁷⁸ The Act resolves the issue of commission rates in favor of fully competitive rates,²⁷⁹ specifically permitting an investment adviser to pay more than the lowest available commission rate.²⁸⁰ It also resolves the issue of institutional membership in favor of open membership²⁸¹ and the conflict of money management and brokerage in favor of a separation of the two functions.²⁸² The Act reverses *Rosenfeld v. Black*,²⁸³ expressly permitting the sale of an investment adviser for more than book value.²⁸⁴ Finally, the Act contains amendments concerning the SEC's authority to investigate violations and to seek injunctions.²⁸⁵

Thus, the Act represents a massive legislative undertaking which is already having far-reaching effects.²⁸⁶ The following discussion summarizes the highlights of this new legislation.

National Market System.—The Act does not mandate the establishment of a single market. Rather, it envisions that through modern electronic techniques, information about transactions in the various exchange and over-the-counter markets can be disseminated in order to permit the public to seek out the best price. The Act gives the SEC authority to develop a national system which will accomplish these legislative goals.²⁸⁷ Pursuant to the new legislation, the SEC has appointed a fifteen-member National Market Advisory Board to advise it on the development of the national market system.²⁸⁸ The Board is authorized to conduct a feasibility study of the need for a new self-

278. See § 19, 15 U.S.C. § 78s (Supp. V, 1975), and text accompanying notes 354-57 *infra*.

279. See § 6(c), 15 U.S.C. § 78f(c) (Supp. V, 1975), and text accompanying notes 360-63 *infra*.

280. See § 28(e), 15 U.S.C. § 78bb(e) (Supp. V, 1975), and text accompanying notes 364-72 *infra*.

281. See §§ 6(b)(2), 15A(b)(3), 15 U.S.C. §§ 78f(b)(2), 78o-3(b)(3) (Supp. V, 1975), and text accompanying notes 351-52 *infra*.

282. See §§ 11(a), 11(b), 15 U.S.C. §§ 78k(a), 78k(b) (Supp. V, 1975), and text accompanying notes 373-81 *infra*.

283. 445 F.2d 1337 (2d Cir. 1971), cert. dismissed, 409 U.S. 802 (1972).

284. See § 15(f) of the Investment Company Act of 1940, as amended by the Act, 15 U.S.C. § 80a-15(f) (Supp. V, 1975), and text accompanying notes 383-86 *infra*.

285. See §§ 21(d), (g), 15 U.S.C. §§ 78u(d), (g) (Supp. V, 1975), and text accompanying notes 387-88 *infra*.

286. The SEC has issued several releases relating to rules and other matters mandated by the Act. See, e.g., SEC Securities Exchange Act Releases No. 11,469 (June 12, 1975); No. 11,595 (Aug. 14, 1975); No. 11,607 (Aug. 20, 1975); No. 11,734 (Oct. 15, 1975); No. 12,030 (Jan. 20, 1976); and No. 12,055 (Jan. 27, 1976). [Hereinafter, all references to releases are to those issued under the 1934 Act, and cited as Release No.].

287. See § 11A(a), 15 U.S.C. § 78k-1(a) (Supp. V, 1975).

288. See § 11A(d), 15 U.S.C. § 78k-1(d) (Supp. V, 1975); Release No. 11,623 (Aug. 28, 1975).

regulatory body to administer the national market system and is to report its recommendations to the Congress by December 31, 1976.²⁸⁹

The Act gives the SEC authority to adopt rules designed to assure "equal regulation"²⁹⁰ of all markets for qualified securities and of all exchange members, brokers, and dealers effecting transactions in such securities.²⁹¹ The SEC is also given authority to facilitate the development of a composite quotation system and a composite tape;²⁹² henceforth all exclusive securities information processors must register with the SEC.²⁹³

289. Section 11A(d)(3)(B), 15 U.S.C. § 78k-1(d)(3)(B) (Supp. V, 1975).

290. Section 3(a)(36), 15 U.S.C. § 78c(a)(36) (Supp. V, 1975), provides:

A class of persons or markets is subject to "equal regulation" if no member of the class has a competitive advantage over any other member thereof resulting from a disparity in their regulation under this title which the [Securities and Exchange] Commission determines is unfair and not necessary or appropriate in furtherance of the purposes of this title.

291. See §§ 11A(a)(1)(C)(ii), 11A(c)(1)(F), 11(b), 15(c)(5), 15 U.S.C. §§ 78k(b), 78k-1(a)(1)(C)(ii), 78k-1(c)(1)(F), 78o(c)(5) (Supp. V, 1975).

The Act also expresses congressional concern for the continued viability of small brokers, requiring the SEC to monitor the effects of the legislation on them and to report to Congress. See text accompanying note 391 *infra*.

292. See §§ 11A(c)(1)-(2), 15 U.S.C. §§ 78k-1(c)(1)-(2) (Supp. V, 1975).

As of January 26, 1976, the consolidated tape has been providing information as to transactions in New York Stock Exchange and American Stock Exchange securities in the exchange and over-the-counter markets. Stock tables for New York and American Stock Exchange listed securities appearing in *The New York Times* and *The Wall Street Journal* now report information on a consolidated basis. The consolidated tape closes at 5:30 p.m., Eastern Standard Time, rather than the 4:00 p.m. closing on the exchanges. However, all vendors of last sale information are currently maintaining separate records so that closing quotations at 4:00 p.m. may be obtained.

For an interesting discussion of the birth pains of the consolidated tape and the central market, see Rustin, *Composite Stock Tape and New Tables Cause Confusion For Investors*, Wall St. J., Mar. 3, 1976, at 1, col. 6.

The Division of Investment Management Regulation of the SEC has indicated that investment companies may continue to price listed securities on the basis of the close of the exchange or switch to pricing on the consolidated tape. The principles of Accounting Series Release No. 118 (Investment Company Act No. 6295) (Dec. 23, 1970), with respect to accounting for investment securities by registered investment companies continue to apply for over-the-counter securities.

293. Sections 11A(b)(1)-(2), 15 U.S.C. §§ 78k-1(b)(1)-(2) (Supp. V, 1975).

Section 3(a)(22), 15 U.S.C. § 78c(a)(22) (Supp. V, 1975), defines exclusive securities information processor as any person engaged in the business of collecting, purchasing or distributing information on transactions or quotations for any security on an exclusive basis on behalf of any national securities exchange or registered securities association or any such exchange or association which engages on an exclusive basis on its own behalf. The SEC has adopted rule 11Ab2-1 under the 1934 Act providing for the registration of exclusive securities information processors and has promulgated form SIP for use in so registering. In addition, the SEC proposed adoption of rules 11Ab2-2 and 11Ab2-3 on annual updating of registration and registration of a successor to a registered processor and rule 11Ab5-1 requiring a processor which limits or prohibits access to its system to give notice to the SEC with an explanation of the reason for any such prohibition or limitation. Since nonexclusive processors are exempt from registration unless the SEC requires registration, it has sought comment on the need for nonexclusive processors to register. Release No. 11673 (Sept. 23, 1975).

One of the fears expressed during the congressional hearings on the legislation was that it would eliminate the auction market.²⁹⁴ The Act seeks to continue an auction market by means of the composite tape and quotation mechanisms and by provisions giving the SEC authority to prescribe rules requiring broker-dealers trading for their own account to yield to public orders.²⁹⁵ Furthermore, the SEC is authorized to eliminate, in effect, the third market by prohibiting the execution of transactions in listed securities off the exchange where the securities are listed. The transactions may be prohibited if the SEC finds on the record and after opportunity for a hearing that as a result of them, the fairness and orderliness of the market for such securities has been adversely affected, the rules of such exchange do not unreasonably impair competition among market makers, including exchange specialists, and the maintenance or restoration of fair and orderly markets in such securities may not be assured through other lawful means.²⁹⁶ In this connection, the Act requires the SEC to review all rules of national securities exchanges which limit the ability of members to effect transactions off such exchanges.²⁹⁷ The principal rule of this nature was New York Stock Exchange (NYSE) rule 394.²⁹⁸ On December 19, 1975, the SEC adopted rule 19c-1 under the 1934 Act, prohibiting any exchange rules which limit the execution of agency transactions off the exchange, except that an exchange may, until January 2, 1977, require that public limit orders on the exchange be satisfied before a transaction is executed off-board. The rule is inapplicable to round lot principal transactions, the SEC reserving decision on this question.²⁹⁹ As a result, the NYSE has rescinded rule 394 and adopted rule 390³⁰⁰ to satisfy the requirements of rule 19c-1.³⁰¹

The Act authorizes the SEC to permit exchanges to extend unlisted trading privileges to certain over-the-counter securities.³⁰² Reflecting a desire to foster inter-dealer and other competition, the Act requires the SEC, in passing upon an exchange application for such privileges, to

294. See Hearings on S. 249 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing & Urban Affairs, 94th Cong., 1st Sess. 198-99 (1975).

295. Sections 11(a)(2), 11(b), 15(c)(5), 15 U.S.C. §§ 78k(a)(2), 78k(b), 78o(c)(5) (Supp. V, 1975).

296. Section 11A(c)(3), 15 U.S.C. § 78k-1(c)(3) (Supp. V, 1975).

This is commonly known as the "failsafe" power reflecting the expectation that it is to be used only as a last resort. See Conference Report, *supra* note 271, at 95.

297. Section 11A(c)(4), 15 U.S.C. § 78k-1(c)(4) (Supp. V, 1975).

298. See 2 CCH N.Y.S.E. Guide ¶ 2,394 (Mar. 31, 1976).

299. Release No. 11,942 (Dec. 19, 1975) (effective Mar. 31, 1976). For the adverse reaction of Congressman Moss to the decision by the SEC to defer acting on principal transactions, see 338 BNA Sec. Reg. & L. Rep. A-7 (1976).

300. 2 CCH N.Y.S.E. Guide ¶ 2,390 (Mar. 31, 1976).

301. See also the new amendments to NYSE rules 395 and 396, *id.* ¶¶ 2,395, 2,396.

302. Section 12(f)(1), 15 U.S.C. § 78l(f)(1) (Supp. V, 1975).

consider among other things, "the desirability of removing impediments to and the progress that has been made toward the development of a national market system."³⁰³ Like its third-market provisions,³⁰⁴ the Act also prohibits the SEC from granting unlisted trading privileges if the rules of the applicant exchange unreasonably impair competition among market makers, including exchange specialists.³⁰⁵

National System for Clearance and Settlement.—The Act mandates the establishment of a national system for clearance and settlement of securities transactions, including the transfer of record ownership.³⁰⁶ Accordingly, the SEC is directed, as it is directed with respect to a national market system,³⁰⁷ to use its powers under the 1934 Act to establish such a system.³⁰⁸ All clearing agencies must register with the SEC,³⁰⁹ and the SEC may not approve the registration of a clearing agency unless it determines that the rules of the agency permit open membership, are designed to perfect the mechanism for a national clearing system, and do not impose an unnecessary burden on competition.³¹⁰ The agency may, however, deny participation to any person subject to a "statutory disqualification," that is, a person who has committed certain specified violations relating primarily to the securities industry, including certain criminal violations.³¹¹ Further, the agency may deny participation to any person not meeting its financial, operational, experience, and competence standards.³¹² The SEC must also find that the agency's rules are designed to promote prompt and accurate clearance and settlement and to perfect the mechanism of a national clearance and settlement system.³¹³ Finally, there must be a finding that the rules of the agency require the appropriate disciplining of participants for violation of its rules and provide a fair disciplinary procedure.³¹⁴

303. Section 12(f)(2), 15 U.S.C. § 78l(f)(2) (Supp. V, 1975).

304. See text accompanying note 296 *supra*.

305. Section 12(f)(2), 15 U.S.C. § 78l(f)(2) (Supp. V, 1975).

306. Section 17A, 15 U.S.C. § 78q-1 (Supp. V, 1975).

307. See text accompanying note 287 *supra*.

308. Section 17A(a)(2), 15 U.S.C. § 78q-1(a)(2) (Supp. V, 1975).

309. Section 17A(b), 15 U.S.C. § 78q-1(b) (Supp. V, 1975). A clearing agency is defined generally in § 3(a)(23), 15 U.S.C. § 78c(a)(23) (Supp. V, 1975), as any person who acts as an intermediary in making payments or deliveries or both in connection with securities transactions, including central securities depositories.

The SEC has adopted rule 17Ab2-1 providing for the registration of clearing agencies and form CA-1 for use in registering. 17 C.F.R. §§ 240.17Ab2-1, 249b.200 (1976).

310. Sections 17A(b)(3), (F), (I), 15 U.S.C. §§ 78q-1(b)(3)(B), (F), (I) (Supp. V, 1975).

311. For a definition of "statutory disqualification," see § 3(a)(39), 15 U.S.C. § 78c(a)(39) (Supp. V, 1975).

312. Section 17A(b)(4)(B), 15 U.S.C. § 78q-1(b)(4)(B) (Supp. V, 1975).

313. Section 17A(b)(3)(F), 15 U.S.C. § 78q-1(b)(3)(F) (Supp. V, 1975).

314. Section 17A(b)(3)(G)-(H), 15 U.S.C. § 78q-1(b)(3)(G)-(H) (Supp. V, 1975).

The Act requires that each transfer agent register with its "appropriate regulatory agency."³¹⁵ The concept of appropriate regulatory agency is a new one, designed to accommodate the fact that banks are active in the clearing and transfer aspects of the securities industry, as municipal securities dealers and also as institutional investment managers. Depending on the bank, its appropriate regulatory agency may be the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, or the Federal Deposit Insurance Corporation (FDIC).³¹⁶ The appropriate regulatory agency may enforce compliance by clearing agencies and transfer agents with rules it adopts.³¹⁷ While clearing agency applications for registration are filed with the SEC, the appropriate regulatory agencies have authority to review them and request the SEC to deny approval.³¹⁸ The Act contains several other provisions relating to the interaction of the SEC with bank regulatory authorities designed to give the bank authorities a major role in the regulation and disciplining of clearing agencies and transfer agents as well as bank municipal securities dealers.³¹⁹

The Act gives the SEC authority to provide for the form and format of securities³²⁰ and requires specified financial institutions customarily involved in the transaction process to report to the SEC or, in the case of specified securities, a Federal Reserve Bank, information with respect to missing, lost, counterfeit, or stolen securities.³²¹ The Act provides that

315. Section 17A(c), 15 U.S.C. § 78q-1(c) (Supp. V, 1975). Section 3(a)(25), 15 U.S.C. § 78c(a)(25) (Supp. V, 1975), defines transfer agent generally as any person who engages on behalf of an issuer or on its own behalf in countersigning securities, acting as registrar, or transferring record ownership of securities by bookkeeping entries.

The SEC, Comptroller of the Currency, Federal Reserve Board and Federal Deposit Insurance Corporation have adopted Form TA-1 for the registration of transfer agents. 17 C.F.R. § 249b.100 (1976). "Transfer agent" includes any person (including issuers who may have transfer agents) if it performs any transfer agent functions such as recording the transfer of its securities on records maintained by it. Release No. 11,759 (Oct. 22, 1975).

316. For a definition of "appropriate regulatory agency," see § 3(a)(34), 15 U.S.C. § 78c(a)(34) (Supp. V, 1975).

317. Sections 17A(d)(1)-(2), 15 U.S.C. § 78q-1(d)(1)-(2) (Supp. V, 1975).

318. Section 19(a)(2), 15 U.S.C. § 78s(a)(2) (Supp. V, 1975).

319. See, e.g., § 13(f)(4), 15 U.S.C. § 78m(f)(4); §§ 15B(c)(5)-(6), 15 U.S.C. §§ 78o-4(c)(5)-(6); §§ 17A(d)(3)-(4), 15 U.S.C. §§ 78q-1(d)(3)-(4); §§ 19(d)-(f), 15 U.S.C. §§ 78s(d)-(f); § 21(f), 15 U.S.C. § 78u(f) (Supp. V, 1975).

320. Section 12(l), 15 U.S.C. § 78l(l) (Supp. V, 1975).

321. Section 17(f)(1), 15 U.S.C. § 78q(f)(1) (Supp. V, 1975).

On January 20, 1976, the SEC proposed adoption of rule 17f-1. The rule would require that certain persons who regularly handle securities submit to the SEC or any federal reserve bank any information relating to lost, stolen, missing, or counterfeit securities. The proposal also requires that each such person make inquiry of the SEC or any federal reserve bank with respect to every security coming into its possession whether the security has been reported as stolen, lost, missing, or counterfeit. Release No. 12,030 (Jan. 20, 1976).

the SEC shall use its authority under the Act to end the physical movement of securities in connection with transaction settlements³²² and requires the SEC to propose legislation to eliminate securities certificates.³²³ State or local transfer taxes based on the location of transfer or clearing facilities in the taxing jurisdiction are prohibited.³²⁴ Finally, the Act directs the SEC to study the practice of recording ownership in street name to determine if the practice is consistent with the purposes of the 1934 Act and whether steps can be taken to facilitate communication with beneficial owners while retaining the street name practice.³²⁵

Regulation of Brokers and Dealers.—The registration and disciplinary provisions of the 1934 Act and the Investment Advisers Act of 1940 have been coordinated.³²⁶ The definition of "interstate commerce" has been amended to include intrastate use of any facility of a national securities exchange or of a telephone or other interstate means of communication.³²⁷ As a result of this amendment and the amendment to the registration provisions, specialists, floor traders, and two-dollar brokers, who previously were not required to register, have been subjected to the registration requirements.³²⁸ Registration is no longer automatic; the SEC must take affirmative action on an application within forty-five days of filing and either grant the application or start proceedings to deny.³²⁹ The Act now requires an examination of a newly registered broker or dealer within six months of the registration to determine whether it is operating in conformity with the provisions of the statute. The examination is to be performed by the SEC or, if it so delegates its authority, by the securities association or exchange of which the broker or dealer is a member.³³⁰

The 1934 Act has been revised so as to give the SEC authority to establish standards of operational capability, training, experience, and

322. Section 17A(e), 15 U.S.C. § 78q-1(e) (Supp. V, 1975).

323. Section 23(b)(4)(E), 15 U.S.C. § 78w(b)(4)(E) (Supp. V, 1975).

On September 15, 1975, the Committee on Stock Certificates of the Section of Corporation, Banking and Business Law of the American Bar Association issued its recommendations on the elimination of stock certificates. The report recommends an amendment to state corporation laws to give corporations the power to issue uncertificated stock and an extensive revision of the Uniform Commercial Code. For a discussion of this project, see Aronstein, *A Certificateless Article 8? Can We Have It Both Ways*, 31 Bus. Law. 727 (1976).

324. Section 28(d), 15 U.S.C. § 78bb(d) (Supp. V, 1975).

325. Section 12(m), 15 U.S.C. § 78l(m) (Supp. V, 1975).

326. Compare §§ 15(b)(2), (4), (6), 15 U.S.C. §§ 78o(b)(2), (4), (6), with the Investment Advisers Act of 1940, §§ 203(c)(1), 203(e), (f), 15 U.S.C. §§ 80b-3(c)(1), (c), (f) (Supp. V, 1975).

327. Section 3(a)(17), 15 U.S.C. § 78c(a)(17) (Supp. V, 1975).

328. See § 15(a), 15 U.S.C. § 78o(a) (Supp. V, 1975).

329. Section 15(a)(b)(1), 15 U.S.C. § 78o(a)(b)(1) (Supp. V, 1975).

330. Section 15(b)(2)(c), 15 U.S.C. § 78o(b)(2)(c) (Supp. V, 1975).

competence for brokers and dealers.³³¹ The Act also requires every broker to file an annual audited balance sheet and income statement with the SEC and such other financial information as the SEC may require. This improvement eliminates the historical "surprise" audits. Further, every registered broker is now required by statute to supply its customers with an annual audited balance sheet and such other information as the SEC may by rule require.³³²

The Act requires the adoption by the SEC of a uniform net capital rule for all brokers and dealers.³³³ This rule, which replaced the net capital rules of registered securities exchanges, became effective in 1975.³³⁴ While a detailed discussion of the new rule is beyond the scope of this article, it should be noted that the rule provides for an alternative net capital computation. Instead of the previous approach of limiting the amount of aggregate indebtedness to net capital (generally fifteen to one in the new rule), the new rule substitutes for the ratio of aggregate indebtedness to net capital the aggregate dollar amount of firm assets which have as their source transactions with customers. The alternative requires a broker or dealer to maintain net capital equal to the greater of \$100,000 or four percent of the aggregate adjusted debit items computed in accordance with the Formula for Determination of Reserve Requirements for Brokers and Dealers³³⁵ (brokers operating under the historical formula must have as little as \$2,500 of net capital or as much as \$100,000, depending on the nature of their business, the standard amount being \$25,000).³³⁶ In addition, the 1934 Act now specifically authorizes the SEC to adopt rules regulating the lending by brokers of securities carried for the account of the customer.³³⁷

Finally, the Act provides that every exchange member, broker, dealer, registered transfer agent, and registered clearing agency shall, except to the extent exempted by SEC rule, require each of its partners, directors, officers, and employees to be fingerprinted.³³⁸

The 1934 Act now provides for the registration of brokers and

331. Section 15(b)(7), 15 U.S.C. § 78o(b)(7) (Supp. V, 1975).

332. Sections 17(e)(1)(A)-(B), 15 U.S.C. §§ 78q(c)(1)(A)-(B) (Supp. V, 1975).

333. Section 17(c)(1)(3), 15 U.S.C. § 78q(c) (Supp. V, 1975).

334. See Release No. 11,497 (June 26, 1975). See also Release No. 11,624 (Aug. 29, 1975) which amends rule 15c3-1, 17 C.F.R. § 240.15c3-1 (1976), to provide an alternative net capital requirement for floor brokers and to treat registered options traders as specialists. See Release No. 11,969 (Jan. 2, 1976).

335. See Exhibit A, 17 C.F.R. § 240.15c3-3 (1976).

336. *Id.* § 240.15c3-1 (1976).

337. Section 8(c), 15 U.S.C. § 78(h)(c) (Supp. V, 1975).

338. Section 17(f)(2), 15 U.S.C. § 78h(c) (Supp. V, 1975). The SEC has adopted rule 17f-2 which exempts certain persons not engaged in the securities transaction process from the fingerprinting requirement. The rule also defers the fingerprinting requirement to Jan. 1, 1977. Release No. 12,214 (July 1, 1976).

dealers in municipal securities.³³⁹ Previously, persons dealing in such securities were not required to register, but were subject to the anti-fraud rules.³⁴⁰ The Act includes within the definition of municipal securities dealer a separately identifiable department or division of a bank and any bank unless it is engaged in buying and selling municipal securities for its own account other than in a fiduciary capacity.³⁴¹ The SEC must affirmatively take action on a registration application in the same manner as with an application by any other broker or dealer.³⁴²

The Act mandates the establishment of a fifteen-member Municipal Securities Rulemaking Board which was established by the SEC in September of 1975.³⁴³ The Board is required to adopt rules with respect to transactions in municipal securities providing at least that all municipal securities brokers and dealers must meet such standards of operational capability, training, and experience and competence as the Board finds necessary. The rules must also be designed to perfect the mechanism of a free and open market in municipal securities. Generally, the rules must be consistent with the national market system which is mandated with respect to other brokers and dealers.³⁴⁴ Primary enforcement of these rules is given to the National Association of Securities Dealers, Inc. (NASD) (with respect to its members)³⁴⁵ or the appropriate regulatory agency for the municipal securities dealer, if the NASD

339. See §§ 3(a)(12), 15a, 15 U.S.C. § 78c(a)(12), 78o(a) (Supp. V, 1975).

340. § 10(b), 15 U.S.C. § 78j(b) (1970) and rule 10b-5, 17 C.F.R. § 240.10b-5 (1976). For recent developments in 10b-5 litigation, see notes 53-121 *supra* and accompanying text.

341. For definitions of municipal securities dealer, municipal securities broker, and related terms, see §§ 3(a)(29)-(33), 15 U.S.C. § 78c(a)(29)-(33) (Supp. V, 1975). See also rule 15b2B-1, 17 C.F.R. § 240.15b2B-1 (1976), with respect to registration of such departments.

342. Sections 15(b)(1), 15B(a)(2), 15 U.S.C. §§ 78o(b)(1), 78o-4(a)(2) (Supp. V, 1975).

The SEC has adopted rules 15Ba2-1 and 15Ba2-2 and form MSD under the 1934 Act with respect to the registration of municipal securities dealers. 17 C.F.R. §§ 240.15Ba2-1, .15Ba2-2 (1976). Banks or separately identifiable departments or divisions of banks which are municipal securities dealers must register with the SEC on form MSD. Intrastate municipal securities dealers must register on form BD. Other municipal securities brokers and dealers must also register on form BD. The Municipal Securities Rule-Making Board (see text accompanying note 343 *infra*), has adopted rules defining separately identifiable department or division. The department is separately identifiable if it conducts all of the bank's municipal activities, and if it is under the direct supervision of an officer designated by the board of directors and maintains separate records. Release No. 11,742 (Oct. 15, 1975).

343. Release No. 11,635 (Sept. 5, 1975); see § 15B(b)(1), 15 U.S.C. § 78o-4(b)(1) (Supp. V, 1975).

344. Sections 15B(b)(1), (2), 15 U.S.C. §§ 78o-4(b)(2)(A), (C) (Supp. V, 1975).

The power of the Municipal Securities Rulemaking Board to promulgate rules does not abrogate the power of the SEC to adopt rules in this area. See section 15B(b)(3), 15 U.S.C. § 78o-4(b)(3) (Supp. V, 1975).

345. Section 15A(b)(7), 15 U.S.C. § 78o-3(b)(7) (Supp. V, 1975).

is not appropriate.³⁴⁶ Ultimate authority rests with the SEC.³⁴⁷ Such dealers by reason of their registering automatically become subject to enrollment in the Securities Investor Protection Corporation.

Section 15B(d) of the 1934 Act,³⁴⁸ known as the "Tower Amendment," specifically provides that no issuer of municipal securities shall be required to file with the SEC or the Board prior to sale, any application, report, or document in connection with such sale, and that the Board may not require the issuer to furnish the Board, a purchaser, or a prospective purchaser with any otherwise not generally available application, report or document with respect to the issuer. The section provides that it is not to be construed to limit or impair the authority of the SEC under any provision of the federal securities laws.³⁴⁹ Since the antifraud rules are applicable to the sale of municipal securities, as a practical matter municipal brokers and dealers are under an obligation to assure themselves that adequate disclosure is made to prospective purchasers. This is normally accomplished by preparation and distribution of an offering circular.³⁵⁰

Regulation and Oversight of National Securities Exchanges and Securities Associations.—The provisions relating to the registration of national securities exchanges and securities associations have been revised to provide that the SEC shall not approve any registration unless it finds that the rules of the applicant provide for open membership and are designed to perfect the mechanism of a free and open market and a national market system. As with clearing agencies, the rules of exchanges and associations must provide for disciplinary action in the event of a violation of the 1934 Act. Finally, the SEC must find that the rules do not impose any unnecessary burden on competition. Again, as with clearing agencies, membership can be denied if the applicant is subject to a statutory disqualification or if he does not meet the exchanges' or associations' standards of training, experience, and competence, or has engaged in or is likely to engage in a practice inconsistent

346. Section 15B(c)(5), 15 U.S.C. § 78o-4(c)(5) (Supp. V, 1975).

347. See § 15B(c), 15 U.S.C. § 78o-4(c) (Supp. V, 1975).

348. Section 15B(d), 15 U.S.C. § 78o-4(d) (Supp. V, 1975).

349. Id.

350. Senator Eagleton recently introduced a bill—S. 2574, 94th Cong., 1st Sess. (1975)—which would require registration with the SEC of municipal securities. Further, Senators Williams and Tower recently introduced the Municipal Securities Full Disclosure Act of 1976 (id., S. 2969) which would require municipalities with \$50 million of securities outstanding to prepare annual reports reflecting their financial condition, including audited financials commencing in 1979, which must be made available to security holders. The bill would also require any issuer of an issue of municipal securities sold through a broker or dealer (in excess of \$5,000,000) to issue a distribution statement containing a description of the offering and information similar to that in the required annual report.

with just and equitable principles of trade.³⁵¹

An exchange is permitted to limit the number of its members (including floor members) except that an exchange cannot decrease the number of its members below the number in effect on May 1, 1975 or the date of the exchange's registration, if later. The SEC can also require an exchange to increase the number of its members if the SEC determines that the limitation imposes unnecessary burdens on competition.³⁵² Furthermore, the Act gives the SEC authority to require a nonmember to comply with specific rules of an exchange if he executes transactions on the exchange without the use of another broker.³⁵³

The 1934 Act gives the SEC authority not only to review proposed rules of self-regulatory organizations, but now provides that the SEC shall have the power upon following a specified procedure to "abrogate, add to, and delete from" the rules of a self-regulatory organization (other than a registered clearing agency) as the SEC deems appropriate and consistent with the 1934 Act.³⁵⁴ The Act provides for direct appeal to the courts of appeals by any person aggrieved by such a rule, as well as rules adopted by the SEC pursuant to other sections and other specified SEC actions.³⁵⁵ Further, the SEC (with respect to persons for whom it is the appropriate regulatory agency) and the other regulatory agencies are given the power, upon following a specified procedure, to review disciplinary actions against members or participants.³⁵⁶ The appropriate regulatory agency is also given power to suspend or revoke the registration of any self-regulatory organization and to suspend or expel a member or participant.³⁵⁷

The Act requires at least one public director of exchanges and associations. The conference report, however, makes clear that this requirement is not meant to repudiate the balanced boards adopted by the NYSE and the American Stock Exchange.³⁵⁸

The Act redesignates section 15(b)(7) as section 15(b)(6) and eliminates the SEC's authority to bring an administrative proceeding

351. See §§ 6(a), (b), (c)(1)-(3), 15 U.S.C. §§ 78f(a), (b), (c)(1)-(3) (Supp. V, 1975). See also §§ 15A(a), (b), (g)(1)-(3), 15 U.S.C. §§ 78o-3, -4, -10(1)-(3) (Supp. V, 1975).

Since banks are not included within the definition of broker or dealer, exchanges and securities associations are not required to permit them to become members, although bank subsidiaries would presumably be entitled to join. See §§ 3(a)(4)-(5), 15 U.S.C. §§ 78c(a)(4)-(5) (Supp. V, 1975).

352. Section 6(c)(4), 15 U.S.C. § 78f(c)(4) (Supp. V, 1975).

353. Section 6(f), 15 U.S.C. § 78f(f) (Supp. V, 1975).

354. Sections 19(b)-(c), 15 U.S.C. §§ 78s(b)-(c) (Supp. V, 1975).

355. Section 25, 15 U.S.C. § 78y (Supp. V, 1975).

356. Sections 19(d)-(f), 15 U.S.C. §§ 78s(d)-(f) (Supp. V, 1975).

357. Section 25(h), 15 U.S.C. § 78y(h) (Supp. V, 1975).

358. Sections 6(b)(3), 15A(b)(4), 15 U.S.C. §§ 78f(b)(3), 78o-3(b)(4) (Supp. V, 1975). See Conference Report, *supra* note 271, at 98.

against "any person" who has committed specific violations. Such power is now limited to actions against "any person associated, or seeking to become associated, with a broker or dealer." However, the SEC has taken the position that a provision similar to former section 15(b)(7) contained in section 9(b) of the Investment Company Act of 1940 continues to give it the authority removed by section 15(b)(7).³⁵⁹

Commission Rates, Paying-Up, Separation of Money Management and Brokerage.—The Act codifies rule 19b-3 under the 1934 Act prohibiting the imposition by any exchange of any schedule of fixed commission rates, except that fixed intramember rates were permitted to continue until May 1, 1976.³⁶⁰ The SEC may authorize the reimposition of fixed rate schedules until November 1, 1976 if it finds that such schedules "are in the public interest."³⁶¹

After November 1, 1976, before the SEC permits the reimposition of fixed rates it must find that they "(i) are reasonable in relation to the costs of providing the service for which such fees are charged (and the Commission [must] publish the standards employed in adjudging reasonableness), and (ii) do not impose any burden on competition in furtherance of the purposes of this title, taking into consideration the competitive effects of permitting such schedule or fixed rates weighed against the competitive effects of other lawful actions which the Commission is authorized to take under this title."³⁶² Prior to November 1, 1976, the normal rulemaking procedures are to be followed with respect to any proposal to reimpose fixed rates. Thereafter, before permitting the reimposition of fixed rates, the SEC must follow a more formal procedure, although not a full hearing on the record.³⁶³

Prior to the imposition of fully negotiated rates, investment managers regularly obtained research services from brokerage firms which also executed transactions for the managed accounts. Negotiated rates, therefore, naturally raise the question of whether a manager must pay the lowest available rate if he receives services in addition to basic execution services. The 1934 Act has been amended specifically to permit any person to pay more than the minimum available commission rate if such person determines "in good faith that such amount of commission was reasonable in relation to the value of the *brokerage and research* services provided . . . viewed in terms of either that particular

359. See 15 U.S.C. § 80a-9(b) (1970).

360. Section 6(e), 15 U.S.C. § 78f(e) (Supp. V, 1975).

361. 5 U.S.C. § 78f(e)(1)(A) (Supp. V, 1975).

362. Id. § 78f(e)(1)(B).

363. Id. Section 6(e)(3), 15 U.S.C. § 78f(e)(3), requires that until Dec. 31, 1976, the SEC is to follow the effects that fully negotiated rates are having on the securities industry and to report the same to Congress on a periodic basis.

transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion."³⁶⁴

Thus, an adviser may "pay-up" for research beneficial to all of his accounts. This section is intended to preempt common law with respect to fiduciary responsibility as well as any federal and state statutory law in effect prior to the Act which would have exposed a fiduciary to liability *solely* for failing to pay the lowest commission cost available.³⁶⁵ Therefore, as has always been the case, a fiduciary must be prepared to demonstrate that the quality of the services received, including the availability and value of research, merited the expenditure for such brokerage and ancillary services.³⁶⁶

The nature of the brokerage and research services that a fiduciary may consider is expansive. The Senate Report specifies that the provision was "intended to comprehend the subject matter in the broadest terms, subject to the good faith standard" of the provision, and that the test for determining when a service is encompassed by the section is "whether it provides lawful and appropriate assistance to the money manager in the carrying out of his responsibilities."³⁶⁷ The services specified in the Act include: (i) furnishing advice, either directly or through publications or writings, as to the value of the securities, the advisability of investing in, purchasing, or selling securities and the availability of securities or purchasers or sellers of securities; (ii) analysis and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts; and (iii) the execution of securities transactions, including the functions which are incidental thereto such as settlement and custody.³⁶⁸

As a result, in selecting a broker and determining the commission rate to be paid, the investment manager is free to consider *all* of the services made available to the manager by the broker. The extent to which a manager may pay for such services through increased commission rates will, of course, depend upon all of the facts, such as the amount of the advisory fee the manager is receiving, whether the fee may be otherwise increased, whether the research being acquired is

364. Section 28(e), 15 U.S.C. § 78bb (Supp. V, 1975) (emphasis supplied).

365. See Senate Report, *supra* note 271, at 69-71.

366. The House Report accompanying H.R. 4111, which was the House version of the Act, states "[i]t is, of course, expected that money managers paying brokers an amount which is based upon the quality and reliability of the broker's services, including the availability and value of research, would stand ready and be required to demonstrate that such expenditures were bona fide." House Comm. on Interstate and Foreign Commerce, H.R. Rep. No. 123, 94th Cong., 1st Sess. 95 (1975) [hereinafter cited as House Report].

367. Senate Report, *supra* note 271, at 71.

368. Section 28(e), 15 U.S.C. § 78bb (Supp. V, 1975).

available for hard dollars, the manager's perception of the quality of the research, the reliability and financial responsibility of the broker, the quality of the broker's back office services, and whether the broker can obtain a more favorable or prompt execution. In summary, the manager must make a decision on the basis of an analysis of the result which the manager reasonably believes will flow from the selection of the broker—will the client be benefitted? In essence, the propriety of paying up will be determined on the basis of general fiduciary principles.³⁶⁹

It should be noted that the Act does not preempt contractual provisions limiting the ability of a fiduciary to "pay-up." Thus, provisions in advisory contracts and trust agreements relating to the execution of brokerage transactions or payment of brokerage commissions are controlling.

To avoid the possibility that it would be construed to permit give-ups and reciprocal practices, the Act provides clearly that only a fiduciary may cause a broker to be paid a higher commission for *that* broker's execution of a transaction if such fiduciary determines that the services received from *that* broker justify the payment.³⁷⁰

The SEC has revised its disclosure guidelines in response to new section 28(e). The staff is no longer requiring investment companies to distinguish between services bought with brokerage and those supplied

369. See Release No. 9,598 (May 9, 1972).

The Act by its terms does not specifically exclude the payment of increased commissions to an adviser-broker. Moreover, S. 470, 93d Cong., 1st Sess. (1973), one of the forerunner bills to the Act, specifically excluded a transaction with an adviser-broker from the provision permitting an adviser to pay-up. However, the Act also differs from S. 470 in that the Act is not limited to paying up for research—it covers "brokerage and research services"—whereas S. 470 only covered research services. Moreover, it is also important to recognize that effective May 1, 1978, advisers are prohibited from executing portfolio transactions for their clients' accounts. See text accompanying note 374, *infra*. Thus, insofar as broker-affiliates are concerned, it would seem that the Act should not be read to permit an adviser-broker to receive additional compensation specifically for research through brokerage commissions. This view is consistent with the position previously taken by the SEC. See Release No. 9,598 (May 9, 1972).

On the other hand, the SEC has made clear that a broker-adviser may receive more than the lowest available commission rate, provided that such rate is at least as favorable to the client as the client would be able to obtain from another qualified firm and provided that the affiliate's rate has not been increased by a research element. Release No. 9,598 (May 9, 1972). In short, the affiliated broker must "stand ready to demonstrate that such expenditures were bona fide." Statement of the Securities and Exchange Commission on the Future Structure of the Securities Markets, at 34 (February 2, 1972).

A developing question under section 28(e) is whether it applies to principal as well as agency transactions, since it speaks only of "commissions," and whether a fiduciary may "pay-up" for research not produced in-house. See PLI Securities Law Institute—III, in 9 Rev. Sec. Reg. 983-84 (1976).

370. See Conference Report, *supra* note 271, at 108.

by the adviser or to state whether the availability of such purchased services is essential to the adviser functioning under his contract. Disclosure of the allocation of costs among clients is also not required. The staff requires only a description of the brokerage practices of the fund³⁷¹ and has indicated that it proposes to issue disclosure guidelines in this area in the near future.³⁷²

While the 1934 Act now provides for open membership,³⁷³ it mandates the separation of money management and brokerage. After May 1, 1978, exchange members will not be able to receive brokerage commissions from managed or affiliated accounts.³⁷⁴ All managed accounts—whether fully discretionary, discretionary, discretionary subject to ratification, or merely influenced—other than accounts of natural persons—are subject to the prohibition.³⁷⁵ The exceptions to the affiliated account prohibition are market maker, stabilizing, arbitrage, odd-lot, and error transactions. The Act instructs the SEC to prevent institutions which were not members on May 1, 1975 from becoming members for the purpose of doing brokerage for managed or affiliated accounts during the period before the prohibition becomes effective. Although the SEC has the statutory authority, the Conference Report specifically enjoins the SEC from broadening the exceptions.³⁷⁶

The Conference Report also requests the Department of Labor and the Internal Revenue Service to conform the Employee Retirement Income Security Act (ERISA)³⁷⁷ to the May 1, 1978 date for the phase-out of the combination of management and brokerage,³⁷⁸ and exemptions have been adopted under the ERISA provisions so that agency transactions effected on behalf of a benefit plan by a broker who also acts as investment adviser are exempt from the prohibited transaction section of ERISA until May 1, 1978 if the broker ordinarily and customarily effected such transactions on May 1, 1975.³⁷⁹

The SEC is given authority to further regulate affiliated transactions both on exchanges and in the over-the-counter market.³⁸⁰ It is authorized to regulate exchange transactions by odd-lot dealers and specialists and

371. See *Securities Week*, Aug. 4, 1975; Oct. 13, 1975; Oct. 20, 1975.

372. See *PLI Securities Law Institute—III*, in 9 *Rev. Sec. Reg.* 983, 984 (1976); 341 *BNA Sec. Reg. & L. Rep.* A-9 (1976).

373. See text accompanying note 351 *supra*.

374. Sections 11(a), (b), 15 U.S.C. §§ 78k(a), (b) (Supp. V, 1975).

375. Release No. 12055 (Jan. 27, 1976).

376. Conference Report, *supra* note 271, at 106.

377. Pub. L. No. 93-406, 88 Stat. 829 (codified in 29 U.S.C. § 1001 and scattered sections of 5, 18, 31, and 42 U.S.C.).

378. Conference Report, *supra* note 271, at 107.

379. 40 *Fed. Reg.* 50845 (1975).

380. Sections 11(a)(2), 11(b), 15 U.S.C. §§ 78k(a)(2)(b) (Supp. V, 1975). See text accompanying notes 295-96 *supra*.

has authority to limit specialist activities to broker or dealer and to prohibit a dealer from acting as a broker in the same security.³⁸¹

The 1934 Act has been amended to require every person, other than a natural person, who invests for his own account, and any person who exercises investment discretion, to file such disclosure reports with the SEC as the SEC may require with respect to portfolios of \$100 million.³⁸² The reports, which disclose the composition of the portfolio, must be filed at least annually and may be required to be filed quarterly.

The effect of the decision of *Rosenfeld v. Black*³⁸³ on the sale of investment advisers was a concern of major implications. The Act adds section 15(f) to the Investment Company Act which permits the sale of an investment adviser at a profit if certain conditions are satisfied.³⁸⁴ An investment adviser may now be sold for more than book value if for three years after the sale seventy-five percent of the directors of the investment company are disinterested and as a result of the sale there is not imposed any "unfair burden" on the investment company. An "unfair burden" includes any arrangement during the two-year period after the transaction whereby the adviser is entitled to receive any compensation directly or indirectly (i) from any person in connection with the purchase or sale of securities or other property to, from, or on behalf of such company, other than bona fide ordinary compensation as principal underwriter for such company, or (ii) from such company or its security holders for other than bona fide investment advisory or other services.³⁸⁵ The seventy-five percent and unfair burden tests are not applicable to a public offering by an adviser which does not result in change in control.³⁸⁶

Miscellaneous Provisions.—SEC Injunctions—The SEC continues to have authority to seek an injunction when it believes a person is engaged or is about to engage in a violation of the federal securities laws.³⁸⁷ Further, the 1934 Act now prohibits the consolidation or coordination of an SEC enforcement action with other private actions without the consent of the SEC.³⁸⁸

Transaction Fees—The transaction fee payable by exchanges has been increased from 1/500 percent to 1/300 percent of the aggregate dollar sales of listed securities other than debt securities. A similar

381. Sections 11(b), 15(c)(5), 15 U.S.C. §§ 78k(b), 78o(c)(5) (Supp. V, 1975).

382. Section 13(f), 15 U.S.C. § 78m(f) (Supp. V, 1975) (\$10 million if the SEC so determines).

383. See text accompanying note 283 supra.

384. 15 U.S.C. § 80a-15(f) (Supp. V, 1975).

385. Section 15(f)(2)(B), 15 U.S.C. § 80a-15(f)(2)(B) (Supp. V, 1975).

386. Section 15(f)(4), 15 U.S.C. § 80a-15(f)(4) (Supp. V, 1975).

387. Section 21(d), 15 U.S.C. § 78u(d) (Supp. V, 1975).

388. Section 21(g), 15 U.S.C. § 78u(g) (Supp. V, 1975).

broker-dealer fee on over-the-counter transactions has been added to the 1934 Act.³⁸⁹

Secondary Mortgage Transactions—The Act also adds section 4(5) to the Securities Act of 1933, providing a limited transactional exemption from its registration requirements for sales (including participations) of promissory notes secured by a first lien on a single parcel of real estate on which is located a dwelling or other residential or commercial structure.³⁹⁰

Congressional Oversight—Congress has taken steps to assure that the SEC will follow through with its obligations under the Act. First, section 23 of the 1934 Act has been amended to require the SEC to include in its annual report: a summary of the SEC's oversight activities with respect to self-regulatory organizations for which it is not the appropriate regulatory agency; information, data, and recommendations on the development of a national clearance and settlement system and the establishment of a national market system; a statement of steps it has taken toward ending the physical movement of securities and its recommendations for legislation to eliminate certificates; a summary of its regulatory activities with respect to municipal securities dealers for which it is not the appropriate regulatory agency; a description of the effect of the absence of fixed rates; and information on the effect its rules have on small brokers and dealers, and its efforts to assure the continued participation by them in the securities markets.³⁹¹ Second, section 35 of the 1934 Act has been amended to provide for the SEC's budgets for fiscal 1976 and 1977.³⁹² Thus, the SEC will have to apply to Congress for additional funds, giving Congress another opportunity to review progress under the Act.

389. Section 31, 15 U.S.C. § 78ee (Supp. V, 1975).

390. 15 U.S.C. § 77(d)(5) (Supp. V, 1975).

391. 15 U.S.C. § 78w (Supp. V, 1975). In this connection, the SEC has adopted a uniform FOCUS report which replaces the several reports which previously had to be filed with the various agencies, thus coordinating the reporting process, and has amended various rules to accommodate the new FOCUS requirement. Release No. 11,935 (Nov. 19, 1975). In addition, a new form U-4 has been adopted for use in registering individuals with the SEC and state regulatory agencies. See Release No. 11,530 (July 10, 1975).

392. 15 U.S.C. § 78kk (Supp. V, 1975).